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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-96

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & Co.,

Petitioners,

—against—

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS, and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

CHARLES J. HECHT
Attorney for Petitioners
60 East 42nd Street
Suite 1760
New York, New York 10017
(212) 490-3232

Of Counsel:

HAIG COSTIKYAN

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Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on April 4, 1977, as amended on May 11, 1977.

Official and Unofficial Reports of the Opinions Below

This case originated by the filing of a complaint by the plaintiffs British American Commodity Options Corp. ("British American") and Lloyd, Carr & Co. ("Lloyd, Carr") in the United States District Court for the Southern

District of New York. Subsequently, an action was instituted in the United States District Court for the District of Columbia by the National Association of Commodity Options Dealers ("NASCOD") and certain constituent members.[1] The Honorable Whitman Knapp consolidated the two cases and rendered a decision granting plaintiffs' motion for a preliminary injunction as to §32.6 of the regulations (commonly called "double segregation") and granting defendants' motion for summary judgment with respect to all other aspects of these regulations. Copies of the trial court's Memorandum and Order and subsequent Order and Judgment appear as Appendices A and B. The case was unofficially reported in the CCH Comm. Fut. L. Rep. ¶20,245.

All parties appealed the case to the United States Court of Appeals for the Second Circuit. That Court rendered a judgment affirming the District Court except for the grant of injunctive relief against the double segregation requirement set forth in §32.6 of the regulations, which it reversed. The Opinion of the Circuit Court is officially reported in 552 F.2d 482 and is unofficially reported in CCH Comm. Fut. L. Rep. ¶20,400. A copy of this Opinion, as subsequently amended, appears as Appendix C.

Jurisdiction

The Opinion and Judgement of the Court of Appeals, printed in Appendix C hereto, which incorporates the

[1] British American Commodity Options Corp. and Lloyd, Carr & Co., were named in such suit without their knowledge and consent. Counsel for NASCOD filed a motion with the United States Court of Appeals for the Second Circuit to delete such companies as party plaintiffs in that action. NASCOD requested and on July 8, 1977 obtained an extension to file its Petition for a Writ of Certiorari.

amendment to the Opinion dated May 11, 1977, was entered on April 4, 1977. The Petitioners' request for reconsideration was denied on June 6, 1977. A copy of that order is printed in Appendix D hereto. On June 14, 1977, the Court of Appeals stayed its mandate in accordance with Rule 41(b) of the Federal Rules of Appellate Procedure. A copy of this order is printed in Appendix E hereto.

The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

The Questions Presented for Review

1. May a governmental agency lawfully charged with regulating an industry adopt an arbitrary and unreasonable regulation with which no member of that industry can comply?

2. May a governmental agency impose and enforce a new licensing scheme which permits it arbitrarily by mere inaction to deprive existing licensed dealers, who meet all the objective standards for licensing, the right to continue to do business without any due process?

3. May a governmental agency impose and enforce this licensing scheme to deny existing employees in this industry the right to earn a livelihood by the mere failure to process their individual registration applications?

4. May a governmental agency impose a licensing scheme which has the effect of preventing entry into this industry of companies and persons who meet all of the objective standards set forth in the pertinent statute and regulations promulgated thereunder?

5. May a governmental agency disregard a specific antitrust statute (7 U.S.C. §19) governing that agency's rule

making powers by establishing a concededly anti-competitive regulatory scheme without any substantial benefit to the public interest?

6. Did the United States Court of Appeals for the Second Circuit improperly extend *United States* v. *Florida East Coast Ry. Co.*, 410 U.S. 224 (1973), in permitting a governmental agency to adopt pervasive new regulations affecting a substantial industry without any meaningful opportunity for that industry's participation in the regulatory process, as required by 5 U.S.C. §553(c)?

7. Did the lower court, and especially the Second Circuit, use the wrong standard in contravention of *Doran* v. *Salem Inn, Inc.*, 422 U.S. 922 (1975) in denying plaintiffs' request for a preliminary injunction?

Constitutional Provisions, Statutes and Regulations Involved

The constitutional provision involved is the due process clause of the Fifth Amendment to the United States Constitution. The statute giving the District Court power to issue the injunction is 5 U.S.C. §706. The rule giving the District Court discretion to enter the injunction is Rule 65 of the Federal Rules of Civil Procedure. The statutory provisions are printed in Appendix F hereto. The principal portions of the regulations involved are printed in Appendix G hereto.

Statement of the Case

Petitioners, British American and Lloyd, Carr, are, respectively, the largest and the second or third largest companies, in the United States specializing in the retail sale

of London commodity options to the general public. As a result of regulations published in the Federal Register on October 8, 1976 (41 Fed. Reg. 44560), petitioners filed a complaint. After a hearing was scheduled the Commodity Futures Trading Commission (the "CFTC") advised the District Court that it was withdrawing these regulations.

On November 24, 1976 the CFTC published new regulations (41 Fed Reg. 41565). Petitioners filed an amended complaint seeking declaratory relief with respect to the legality and constitutionality of these regulations under 5 U.S.C. §553, 5 U.S.C. §706, 7 U.S.C. §19 and the Fifth Amendment to the United States Constitution. After the District Court scheduled a hearing on petitioners' motion for a preliminary injunction another suit questioning these regulations was filed in the United States District Court for the District of Columbia, which on motion of NASCOD's counsel was consolidated with this action.

As set forth in printed Appendix A hereto the District Court granted plaintiffs' motion for a preliminary injunction with respect to Section 32.6 of the regulations ("double segregation"), specifically finding that double segregation is arbitrary and unreasonable and would immediately force all existing specialty dealers out of business. The District Court granted defendants' cross motion for summary judgment with respect to the legality and constitutionality of the other portions of these regulations. The Court of Appeals for the Second Circuit reversed the preliminary injunction as to Section 32.6 and affirmed the District Court's decision with respect to the balance of the regulations. Although the Circuit Court denied petitioners' request for reconsideration, they granted petitioners' motion for a stay of mandate pending filing a petition for a writ of certiorari.

Reasons for Granting the Writ

This case satisfies all of the traditional prerequisites for granting a writ of certiorari.

1. This is the first case to be presented to the Supreme Court with respect to a recently created federal regulatory agency.

2. The pervasive regulatory scheme contains a number of unique provisions which have never been considered by the Supreme Court.

3. The questions are close, complex, difficult and are of widespread importance. Their resolution will have an immediate and substantial impact on all existing firms selling London commodity options, their thousands of employees and the existing rights of over 100,000 beneficial owners of commodity options, the investing public in general, as well as, trade relations with Great Britain.

4. There is substantial disagreement amongst the lower courts with respect to the legality and constitutionality of double segregation which should be promptly resolved by the Supreme Court. Subsequent to the Second Circuit's reversal of the District Court's ruling on double segregation the United States District Court for the Northern District of Georgia (Atlanta Division) found the Second Circuit's opinion unpersuasive and granted a specialty dealer a preliminary injunction pending appeal. The Order and Opinion of that Court are printed as Appendices H and I hereto.

5. Under the licensing portion of the challenged regulations the CFTC is unconstitutionally empowered to deprive the petitioners as well as thousands of existing employees of all specialty dealers and numerous individuals who want to become employed in this industry from earning a livelihood. The Court should promptly rectify this serious injustice.

6. This is the first case to reach the Supreme Court which presents the issue of whether a federal regulatory agency may disregard a Congressionally mandated anti-trust policy [7 U.S.C. §19] directed to the agency's authority to promulgate rules and regulations.

7. This case also squarely presents the constitutional issue of whether the Supreme Court should extend *United States* v. *Florida East Coast Ry. Co.*, 410 U.S. 224 (1973) to sanction the denial by a federal regulatory agency of any meaningful participation by the regulated parties in the formulation of new regulations which will have a substantial impact on the industry, its existing customers and the investing public in general.

8. The Second Circuit's approach to the propriety of the denial of a motion for a preliminary injunction by summary judgment directly conflicts with the holding of the Seventh Circuit Court of Appeals in *Progress Development Corp.* v. *Mitchell*, 286 F.2d 232 (7th Cir. 1961) and the criteria for granting or denying a preliminary injunction as set forth by the Second Circuit and the Supreme Court of the United States.

I. General Background

For the convenience of the Court, set forth below is a brief synopsis of the background underlying this litigation. As a result of the Goldstein, Samuelson situation in 1971, which involved the sale of naked options, i.e. where the dealer never purchased the option in London, the Commodity Exchange Act was amended in 1974 to create a new agency, patterned after the Securities and Exchange Commission, to regulate transactions in commodity futures contracts and commodity options. At the present time, the business transacted by the petitioners is limited to the purchase and sale of commodity options on the International Commodity Clearing House (the "ICCH") and the London Metals Exchange (the "LME") in London, England.[2] Under the Commodity Exchange Act of 1974, as amended, ("the Act"), 7 U.S.C. §6c(b), the CFTC was given the authority to promulgate rules or regulations relating to commodity option transactions. Initially, in 1975, the CFTC adopted a broad anti-fraud rule which is applicable to London commodity options. Thereafter on October 22, 1975, the office of General Counsel of the CFTC issued an interpretive letter requesting that all London commodity option dealers, and their principals, but not the sales employees thereof, register with the CFTC as commodity trading advisers ("CTA").

As a result of such legislation a new specialty investment industry was created which as of the time the recent regulations were adopted consisted of approximately 70 companies with over 5,000 employees and approximately

[2] At the present time there is no mechanism for trading in domestic commodity options. New regulations have been proposed with respect thereto (42 Fed. Reg. at pp. 18262 et seq. April 5, 1977).

100,000 customers. On February 20, 1976, the CFTC published proposed regulations relating to commodity option transactions (41 Fed. Reg. Vol. 41, No. 35) which were totally different from the regulations finally adopted. Subsequently, the CFTC formed an Advisory Committee, which failed to include any member of the London commodity options industry. On October 8, 1976, the CFTC published in the Federal Register an extensive set of new regulations relating to commodity options transactions. These were withdrawn and on November 24, 1976 the CFTC published revised regulations relating to commodity option transactions.

II. Double Segregation

The most controversial section of the new regulations is Section 32.6 ("double segregation") which requires that each dealer segregate in a special account 90 percent of all customer funds received until the customer's option is either exercised or abandoned. Ethical dealers, such as the petitioners, unlike Goldstein, Samuelson, actually purchase the option on the ICCH or LME. Accordingly, under double segregation the petitioners would also be required to transmit their own funds, normally equal to approximately 70% of the customers total purchase price, to London to purchase the option for the benefit of its customer. Annexed hereto as a supplement is a table setting forth a cash flow analysis, based on the income statement of British American furnished to the lower courts, of one option transaction without the imposition of double segregation. Under double segregation using an option that costs the customer $2,250 the dealer would be required to segregate in a special bank account $2,025, leaving a balance of $225. The dealer would then be required to expend the following:

(a) To purchase the option	$1,550.00
(b) Sales commissions	236.00
(c) Indirect expenses	248.34
TOTAL	$2,034.34

Thus, everytime a dealer sells an option he creates an approximate 900% negative cash flow and a cash deficit of $1,809.34. As hereinafter explained in detail dealers cannot use the $2,025 placed in the segregated account as collateral to finance the purchase of the option or its operating expenses.

The London exchanges, and in particular the ICCH, have set up extensive safeguards to ensure that when the beneficial owner of the option elects to exercise the option, the option will be exercised. The record is uncontroverted that during the last 125 years there has never been a default on either of these two exchanges.

To this writer's knowledge, there is not one firm presently engaged in the retail sale of commodity options who can comply with double segregation and, unless enjoined, participation in this industry by existing members will be limited to two firms, Rosenthal & Co., and International Trading Group, both of whom were granted limited exemptions.[3] These exemptions were granted pursuant to Section 32.4(b) of the regulations, which are absolutely devoid of any standards or criteria. Accordingly, the

[3] Rosenthal & Co., a diversified commodities dealer, which is substantially larger than British American, whose primary business is the sale of domestic futures contracts, recently consented to a preliminary injunction for alleged violations of the anti-fraud rules relating to its sale of commodity options (*CFTC* v. *Rosenthal & Co.*, 76 Civ. 3094 U.S.D.C., N.D. Ill., Eastern Div.).

CFTC has the "right", which it has exercised, to abitrarily select which firms will be permitted to remain in business.

The rationalization put forth by the CFTC and apparently accepted by the Second Circuit is that "financially stable firms may be able to meet the capital requirements of segregation by borrowing and using the interest they can obtain on the segregated funds to defray a good part of the cost of borrowing." The District Court specifically found that the CFTC's suggestion that double segregation could be complied with by bank financing was not persuasive (footnote 29a). Moreover, the Second Circuit's interpretation ignores the minimum capital requirement ($50,000) set forth in the new regulations and renders it totally meaningless. In fact, the dealers in this industry, including the petitioners, who far exceed the minimum financial requirements adopted by the CFTC, have vainly attempted to obtain financing and as of the date hereof no one has been successful. The basic reason is that the financing requirements for each dealer will run anywhere from eight million dollars to thirty million dollars. Customers' segregated accounts by definition are not acceptable collateral to a lending institution as the purported purpose of a segregated account is to give the customers a first lien on these funds. Thus, for example, British American which has a net worth in excess of $500,000 is unable to obtain the financing needed to comply with double segregation, estimated to be in excess of twenty million dollars. The CFTC admitted before the District Court that only four or five of the largest diversified securities and commodity dealers with substantial capital over and above the capital requirements of their other lines of business would be able to shoulder the "double segregation" burden.

The Second Circuit adhered to the CFTC's contention that double segregation is required as a minimal protective

measure to ensure fulfillment of the option transaction, although the record discloses that the CFTC's Advisory Committee recognized that double segregation may not protect customers or be legally effective under the bankruptcy law (A 139, 157).* Since the CFTC has never attempted to obtain appropriate clarifying legislation with respect to the bankruptcy act, it is doubtful that double segregation while having a devastating impact on the industry can even accomplish its purported basic goal.

The gist of the Second Circuit's opinion, especially as to double segregation, appears to be that since the CFTC could have banned trading in commodity options entirely,[4] so long as it "considered" various alternative approaches, whatever it adopted short of abolition was not arbitrary or unreasonable.

Furthermore, in legitimizing double segregation the Second Circuit over-looked the difference between a commodity futures dealer who can net out other customers futures contracts or, in the case of a securities broker-dealer, utilize customers' securities on margin, to finance the purchase of a commodity futures contract and a dealer specializing in commodity options who is not permitted to

[4] Such a prohibition would have been contrary to the findings of the CFTC's own Advisory Committee. In arriving at its decision the Second Circuit made certain crucial factual assumptions which were either wrong or not supported by the record, to wit: (i) this was a previously unregulated industry when, in fact, companies had been required to register under 7 U.S.C. §6(n) and were subject to numerous regulations, including a broad anti-fraud rule; (ii) assuming that commodity options are less expensive than futures contracts and thus are peculiarly attractive to individual investors of relatively modest means with a propensity for taking risks and, that option investors thus need more protection when, in fact, futures contracts are purchased on 5% to 10% margin and, thus require a far smaller initial investment and are much more leveraged than commodity options.

* Record on Appeal.

net out customers positions or otherwise use its customers equity as collateral to secure the requisite financing.[5]

The purchase of the options with the dealer's funds can only be financed independently of the specialty dealer's operations as there is no legitimate business which operates at 90% after-tax profits. The denial of the use of operating revenues for a substantial period of time would be ruinous. The Second Circuit Court's statement that "it [double segregation] threatens to restrict participation in the industry to soundly capitalized firms" is an understatement. British American and Lloyd, Carr, as well as a number of other dealers, have capital far in excess of what is required by Regulation 1.17 but are totally unable to comply with the double segregation requirements.

The CFTC's justifications for double segregation are not supportable. The imposition of double segregation, *even assuming appropriate financing were available,* would encourage fraud and unfair dealing, and would be prejudicial to the customer:

> (a) It would encourage naked options, which are not presently prohibited, which was the sole and/or principal cause of the Goldstein-Samuelson, J.S. Love and United Kingdom situations. Obviously, if naked options are sold, the dealer must recommend options on which he believes his customer will lose money in order to stay in business. The dealer is betting against the customer. Moreover, since the dealer is not transmitting the funds to buy an option in London,

[5] Efforts to obtain financing through major broker-dealers have also proved fruitless since the enormous amounts of capital so loaned would be a charge against capital and thus could place them in violation of the SEC net capital rule and the NYSE net capital requirements.

the adverse financial impact of double segregation is effectively avoided. In short, the CFTC is now encouraging the very method of doing business which caused the Goldstein, Samuelson debacle. It is conceded on the record that the petitioners do not deal in naked options.[6]

(b) Alternatively, dealers would be required to recommend very short term options which would satisfy the best interests of the dealer in that segregated funds would be promptly released but would be generally contrary to the best interests of the customer. It is elementary that the longer the option period the better chance the customer has to realize a profit. Commodity options are not short term trading vehicles resulting in a substantial number of commissions to the dealer.[7]

(c) The cost to the investor will be increased substantially, which the CFTC concedes but apparently justifies in the name of the additional protection supposedly afforded by double segregation. It is estimated that these direct costs could be in excess of $200 per transaction.

In summary, double segregation violates every tenet of business and common sense.

[6] Both British American and Lloyd, Carr have taken the position that they will *not* sell naked options and believe that except under unusual circumstances, 30-day options are not a suitable investment vehicle from the customer's point of view.

[7] Under Reg. 1.17(c)(2) funds segregated with respect to options with an expiration date of a year or more are not includible as a current asset for working capital purposes.

III. Registration

Under 7 U.S.C. §§6f and 6k[8] and Section 32.3 of the regulations all existing dealers and sales employees were required to be *registered,* as distinguished from filed, by January 17, 1977. There is no statutory or regulatory requirement that the CFTC timely or properly process these applications. In January 1977 the CFTC took the arbitrary position that it was under no obligation to process within the foreseeable future any application filed after December 27, 1976.[9]

The CFTC's interpretation of this regulation as to Lloyd, Carr, which was already registered as a CTA represents the ultimate due process "Catch 22". Lloyd, Carr filed its application as a futures commission merchant ("FCM") on October 1, 1976. As of January 17, 1977 the CFTC had not acted upon its FCM application. The CFTC staff then ordered Lloyd, Carr to immediately cease all operations since it was not yet registered as an FCM leaving Lloyd, Carr with Hobson's choice of shutting its doors immediately or being deemed unfit to be registered if it continued to do business. Although the CFTC's

[8] 7 U.S.C. §6n, which relates to a CTA, unlike Section 32.3 and the above statutes, contains a prescribed time period within which the staff must act with respect to a registration application. Prior to the institution of this litigation a federal court held that the CFTC's failure to expeditiously proceed with an administrative hearing on a CTA application may be violative of constitutional due process. *CFTC* v. *British American Commodity Options Corp.*, 422 F.Supp. 662—footnote 6 to Appendix (S.D.N.Y. 1976).

[9] British American filed its application on December 29, 1976, utilizing its financial statements for the month ended November 30, 1976. Both the District Court and the Circuit Court recognized that there were conflicting staff interpretations in December 1976 as to the proper method of computing net capital, which were not resolved until December 21, 1976, the date of Judge Knapp's opinion.

request for a preliminary injunction to put Lloyd, Carr out of business based on this theory was rejected by a federal court, *CFTC* v. *Lloyd, Carr & Co., et al.* (77-371 T D.C. Mass.), an Administrative Law Judge of the CFTC has filed a recommended decision holding that this is a legal and proper basis to deny Lloyd, Carr's FCM application, to revoke its registration as a CTA and to impose fines in excess of $125,000. The CFTC's licensing scheme and enforcement thereof violates both 5 U.S.C. §558(c) and *Pan Atlantic Steamship Corp.* v. *Atlantic Coastline Railroad Co. et al.*, 353 U.S. 436 (1957). The CFTC's theory has also been approved by another Administrative Law Judge with respect to British American.[10]

The Second Circuit's holding on this issue is that since these petitioners did not promptly file their FCM registration applications they are not in a position to complain is not only contrary to the record but completely avoids the important constitutional questions involved.[11]

Even more significant was the failure of the Circuit Court to consider the rights of thousands of employees who filed associated persons ("AP") applications prior to January 17, 1977 which are still not processed.[12] Consistent with their prior public releases the CFTC has taken the

[10] As of the date hereof the Commission has not rendered its decision in either of these administrative proceedings.

[11] The regulations published on November 24, 1976, contain a CFTC statement that it would take up to 60 days to process applications. January 17, 1977 is less than 60 days from November 24, 1976.

[12] At the conclusion of oral argument the panel requested a written report from the CFTC as to the status of the registration applications. The CFTC refused to comment on the status of the individual AP applications. If the writ is granted petitioners intend to move for permission to file this letter as a supplemental appendix, if not included as part of the record.

position that so long as such persons are not yet registered as APs, they cannot legally perform their jobs. As a condition precedent to processing these AP applications the CFTC has been requiring an affidavit that any such person has not been employed by a commodity option dealer since January 17, 1977. In short, these persons have been deprived of the right to earn a livelihood without any hearing in direct contravention of the most elemental due process. *Yick Wo* v. *Hopkins,* 118 U.S. 356, 369, 370 (1886); *Hornsby* v. *Allen,* 326 F.2d 605 (5th Cir. 1964) cited with approval in *Goldberg* v. *Kelly,* 397 U.S. 254 (1970). This has created utter chaos in the industry and in its recent press releases the CFTC acknowledges that there are thousands of unprocessed individual AP applications. Many of these applications were filed over 6 months ago and involve individuals with impeccable credentials.

The licensing scheme also poses a major threat to the ultimate survival of specialty dealers since they cannot obtain new employees. A competent individual cannot be expected to go without work for six months to a year waiting for the CFTC to process his application.[13] This scheme also discourages the entry of new companies, especially those which are not engaged in another line of business.

IV. Anti-Trust Considerations

7 U.S.C. §19, reprinted in Appendix F hereto, is a unique statute in that Congress has categorically directed the CFTC to take into consideration the public interests to be protected by the anti-trust laws *and* endeavor to take

[13] An employee of a securities broker-dealer or commodity futures dealer can continue to sell stocks, bonds, and futures contracts until his application is accepted.

the least anti-competitive means of achieving the objectives of the Act in issuing any regulation. Both the District Court and the Second Circuit found that many aspects of the regulations, including double segregation, were anti-competitive. The District Court ruled that so long as the agency stated that it had considered the anti-trust problems the regulations, no matter how anti-competitive, complied with the statute. The Second Circuit never discussed this issue.

It is respectfully submitted that this "reading" contradicts not only the underlying legislative history (1974 U.S. Code Cong. Adm. News pp. 5847 and 5863) but sets a dangerous precedent for the federal bureaucracy because for all practical purposes it permits any agency to disregard with impugnity a specific Congressional mandate to foster competition.

In contrast to the instant case, in the absence of a specific Congressional mandate to foster competition, another circuit court has not hesitated to declare unlawful and set aside agency actions which do not give effect to the federal anti-trust laws. *Pillai* v. *C.A.B.*, 485 F.2d 1018 (D.C. Cir. 1973); *Overseas Media Corp.* v. *McNamara*, 385 F.2d 308 (D.C. Cir. 1967); and *Hecht* v. *Pro-Football, Inc.*, 444 F.2d 931 (D.C. Cir. 1971), cert. denied, 404 U.S. 1047, 92 S. Ct. 701, 30 L.Ed.2d 736. The fact that the CFTC deems it in the public interest to eliminate all existing specialty dealers, either immediately through double segregation or slowly with its licensing scheme or discriminatory disclosure requirements and net capital computations, and replace them with the 5 or 6 major securities and commodities broker-dealers or specialty dealers arbitrarily selected by them is not consistent with the purposes of the Act.

V. Procedural Claims

It is respectfully submitted that in view of the scope, nature and material impact of the regulations on parties who were previously regulated by the CFTC, a fair reading of the entire record, wholly apart from the defendants' self-serving conclusions which were taken at face value, would have led to a contrary result in the Circuit Court. *Citizens To Preserve Overton Park* v. *Volpe*, 401 U.S. 402 (1971). The record clearly indicates, as found by Judge Knapp, that these regulations were rushed through. Moreover, the record clearly shows that the procedures and tactics adopted by the defendants were designed at every stage to minimize any meaningful participation of the regulated parties in the rule making process in contravention of 5 U.S.C. §553 and 7 U.S.C. §6c(b). It is respectfully submitted that *United States* v. *Florida East Coast Ry. Co.* (supra) is factually inapposite[14] and actually supports petitioners. If this decision is allowed to stand, federal agencies will be free to deny regulated parties the right to meaningful participation in the regulatory process.

However, of even greater importance is the rationale that so long as a federal regulatory agency makes a statement, irrespective of its truth or falsity or relationship to the rules being adopted, justifying emergency effectiveness of a rule or regulation the courts and the regulated parties are foreclosed from questioning the legality of notice under 5 U.S.C. §553 and 5 U.S.C. §706(2)(D).

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[14] In that case the I.C.C. conducted extensive hearings where witnesses were examined, asked for detailed information from the parties to be regulated and then furnished comments to all parties. The issue was whether the agency was required to hold additional hearings. Moreover, the I.C.C. was not subject to a specific statute such as 7 U.S.C. §6c(b).

Sections 32.8 and 32.9, the so-called anti-fraud rules, are identical to the anti-fraud rule published on July 24, 1975, which have always been applicable to the petitioners and all other members of the industry and their employees. *CFTC* v. *J.S. Love & Associates Options, Ltd.*, 422 F.Supp. 652 (S.D.N.Y. 1976). *A fortiori* the alleged necessity to promptly afford the public protection from fraud, under these facts, clearly does not constitute "for good cause found and published with the rule" within the meaning of 5 U.S.C. §553(d)(3). Secondly, although the competitors of London commodity option dealers participated and in fact were responsible for substantially all of this series of new regulations, public participation by the parties to be directly regulated and customers who have a substantial interest was denied. In view of the nature, scope, and arbitrary time limits, some of them announced after November 24, 1976, imposed by the CFTC petitioners as well as thousands of individuals were materially prejudiced.

It is incumbent upon the judiciary to carefully analyze, where appropriate, an agency's justification for waiving the notice requirements required by the Administrative Procedures Act. Otherwise, for all intents and purposes the notice provisions of 5 U.S.C. §553 and the whole concept of participation in the regulatory process by the parties to be regulated become absolutely meaningless.

It is respectfully submitted that the District Court's rulings, and in particular the Circuit Court's holding with respect to double segregation, are contrary to the proper tests for granting an injunction as recently set forth in *Doran* v. *Salem Inn, Inc.*, 422 U.S. 922 (1975) and the prior holdings of the Second Circuit as recently set forth in *Sonesta Int'l. Hotels Corp.* v. *Wellington Associates*, 483 F.2d 247 (2nd Cir. 1973). Double segregation concededly will put the petitioners as well as substantially all of the members of this industry out of business. There

has been no showing that the failure of existing dealers to double segregate has cost the investing public one penny during the pendency of this litigation. The only survivors and beneficiaries of this series of regulations will be the two companies who have been arbitrarily granted limited exemptions by the CFTC and a very limited number of major securities and commodities broker-dealers who will dominate this industry.

Furthermore, the Second Circuit's denial of a preliminary injunction by summary judgment is contrary to the holding of the Seventh Circuit in *Progress Development Corp.* v. *Mitchell,* (supra). The practical effect of the Second Circuit's ruling is to transform a request for a preliminary injunction into a trial on the merits, thus destroying the whole purpose of a preliminary hearing to determine whether to maintain the status quo. Accordingly, the Supreme Court should clarify this conflict between the Circuit Courts.

CONCLUSION

Based on the foregoing the undersigned on behalf of the petitioners respectfully requests that certiorari be granted.

Respectfully submitted,

Charles J. Hecht
Attorney for Petitioners
60 East 42nd Street
Suite 1760
New York, New York 10017
(212) 490-3232

Of Counsel:
HAIG COSTIKYAN

SUPPLEMENT

Total cost of option to customer		$2,250.00
Premium transmitted immediately to London as payment to the writer of the option		1,550.00
Gross commission of British American before expenses		700.00
Commissions payable to executing brokers and sales employee(s)		236.00
Gross profit on transaction prior to allocation of indirect expenses:		464.00
Indirect expenses:		
Telephone	$126.92	
Rent	6.16	
Indirect sales expenses	32.47	
Back office salaries and computer expenses	20.11	
Legal and accounting	35.10	
Officer salaries	2.28	
Research department	11.20	
Misc.	14.10	
Total indirect expenses		248.34
Pre-tax profit		215.66
Provision for taxes		133.00
Net after-tax profit on transaction		82.66

APPENDIX

Appendix A

(Memorandum and Order)

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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76 Civ. 5124

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & CO.,

Plaintiffs,

—against—

WILLIAM T. BAGLEY, Chairman of the COMMODITY FUTURES TRADING COMMISSION: JOHN V. RAINBOLT III, Vice Chairman of the COMMODITY FUTURES TRADING COMMISSION: READ P. DUNN, GARY SEEVERS and ROBERT L. MARTIN, Commissioners of the COMMODITY FUTURES TRADING COMMISSION,

Defendants.

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76 Civ. 2250

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, a non-profit association, BRISTOL OPTIONS INC., CHARTERED SYSTEMS CORPORATION, BRITISH AMERICAN COMMODITY OPTIONS CORPORATION, CLEARY TRADING COMPANY, INC., FIRST NEW YORK COMMODITY OPTIONS, LTD., FIRST WESTERN COMMODITY OPTIONS, INC. OF LOS ANGELES, WILLISTON CORPORATION, LLOYD, CARR AND COMPANY and INTERNATIONAL COMMODITY OPTIONS, LTD.,

Plaintiffs,

—against—

THE COMMODITY FUTURES TRADING COMMISSION, WILLIAM T. BAGLEY, Chairman COMMODITY FUTURES TRADING COMMISSION, JOHN B. RAINBOLT, II, Vice Chairman COMMODITY FUTURES TRADING COMMISSION, GARY SEEVERS, Commissioner COMMODITY FUTURES TRADING COMMISSION, READ P. DUNN, Commissioner COMMODITY FUTURES TRADING COMMISSION and ROBERT L. MARTIN, Commissioner COMMODITY FUTURES TRADING COMMISSION,

Defendants.

Appendix A

KNAPP, *D.J.*

Plaintiffs British American Commodity Options Corporation, Lloyd, Carr & Company, and the National Association of Commodity Option Dealers, et al.,[1] seek both injunctive and declaratory relief to restrain the defendants, Commissioners of the Commodity Futures Trading Commission (hereinafter "the Commission"), from enforcing regulations concerning commodity option transactions published in the Federal Register on November 24, 1976 of which part went into effect on December 9, part is to go into effect on December 27, and the balance is to go into effect on January 17, 1977. 41 Fed. Reg. 51808. Plaintiffs have moved for a preliminary injunction, and defendants have cross-moved for summary judgment. For the reasons which follow, we in part grant and in part deny defendants' motion for summary judgment; and we grant plaintiffs' motion for a preliminary injunction with respect to the portion of the regulations which is to take effect on December 27, 1976, and otherwise deny such motion.

The jurisdiction of this court, which the defendants have not contested, is premised on 5 U.S.C. §701 et seq., 7 U.S.C. §3, 28 U.S.C. §1331, 28 U.S.C. §1337, 28 U.S.C. §2201 and §2202.

The plaintiffs are dealers in "options" in certain commodities trading on certain exchanges in London, England.

[1] The National Association of Commodity Option Dealers, et al. filed its complaint in the District Court for the District of Columbia, and the case was assigned to Judge Robinson, 76 Civ. 2250. Upon hearing that the issues had already been presented to this court and might be decided here first, they consented to a change of venue. They then appeared and argued at the hearing on the instant motions held in this court on December 10, 1976. Judge Robinson granted a change of venue to this court on December 14, 1976. Plaintiffs then moved to consolidate their complaint with that of plaintiffs British American and Lloyd, Carr. We hereby grant that motion.

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That is to say they sell their U.S. customers options to buy futures contracts traded on those exchanges. They mount a wide variety of attacks upon the rules and regulations of the Commission. We find only one of these to have merit, and the major part of this opinion will be devoted to explaining our difficulty with that regulation. Thereafter we shall briefly deal with plaintiffs' other criticisms. The regulation as to which we find the complaint to have merit is the one, effective December 27, 1976, which requires plaintiffs to segregate 90% of the price their customers pay them for the options. In view of the circumstance that the nature of plaintiffs' business—in which they act as agents for London principals—requires them to immediately transfer to London about 75% of such purchase price, we find this segregation requirement to be a hardship which—as we shall develop—the Commission does not seem to have adequately justified.

FACTS

On October 23, 1974 the Congress enacted the Commodities Futures Trading Commission Act of 1974 (hereinafter "the 1974 Act"). 88 Stat. 1389. This Act in effect constituted a series of amendments to the Commodity Exchange Act, which had initially been enacted in 1936. The 1974 Act created the Commission as an independent federal regulatory agency, and referred to it certain regulatory functions previously within the jurisdiction of the Department of Agriculture. The Act further vested the Commission with additional authority.

As enacted in 1936, the Commodity Exchange Act set up methods of regulating trade in contracts of sale for future delivery of certain commodities ("futures"). That Act also prohibited trading in "options" with respect to the com-

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modities regulated.[2] The 1936 Act covered only specifically designated commodities.[3] The 1974 Act expanded the definition of commodities subject to regulation to include virtually all previously unregulated commodities, by bringing within its scope all "goods and articles . . . and all services rights and interests in which contracts for future delivery are presently or in the future dealt in . . ." [4]

With respect to the commodities previously regulated, the 1974 Act continued the absolute prohibition on trading in options.[5] However, with respect to trading in options in the newly covered commodities, the 1974 Act authorized the Commission either to extend the absolute prohibition to such trading or to subject it to regulation.[6]

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[2] A commodity option gives the purchaser the right, during a specified period of time, to buy ("call") and/or sell ("put") at a set price a specific futures contract or, in the case of an option on an actual commodity, a specific quantity of that commodity. In the case of so-called "London options" of the type offered by plaintiffs here, the option relates to futures contracts on commodities traded on the London commodity markets.

[3] Commodities Exchange Act §2(a), 7 U.S.C. §2. The number of commodities regulated increased from time to time after 1936. See the Advisory Committee Report to the Commission, July 6, 1976 ("the Advisory Committee Report"), p. 96, n. 37.

[4] Commodity Futures Trading Commission Act of 1974, §201, Section 2(a) of the Commodities Exchange Act as amended, 7 U.S.C. §2 (Supp. V, 1975).

[5] Commodity Futures Trading Commission Act of 1974, §402, Commodities Exchange Act as amended, §4c(a), 7 U.S.C. §6c(a) (Supp. V, 1975).

[6] Commodity Futures Trading Commission Act of 1974, §402, Commodities Exchange Act as amended, §4c(b), 7 U.S.C. §6c(b) (Supp. V, 1975). The 1974 Act also gave the Commission exclusive jurisdiction to regulate these. Commodities Exchange Act §2(a)(1), 7 U.S.C. §2 (Supp. V, 1975).

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The plaintiffs in this action deal in "options" in previously unregulated commodities[7] and challenge the regulations the Commission has imposed upon them pursuant to the 1974 Act.

So far as here relevant, the pertinent statute provides:

> "No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this Act, but not specifically set forth in section 2(a) of this Act, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty', contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets." [8]

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[7] Plaintiffs British American and Lloyd, Carr act as agents for others who write options on two London exchanges.

[8] The 1974 Act §402, the Commodities Exchange Act as amended §4c(b), 7 U.S.C. §6c(b) (Supp. V, 1975).

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Legislative History of the 1974 Act

The Congressional decision to expand the commodities subject to regulation arose out of the financial failure of at least one company, Goldstein, Samuelson, Inc. which sold options in the unregulated commodities for which no underlying futures contract had been purchased so that customers who tried to exercise their options were defrauded. Congressional hearings focused on this scandal.[9]

This led the House of Representatives to first consider a bill which expanded the commodities subject to regulation and extended the prohibition on trading in options to all these commodities. HR. 11955.[10] However, follow-

[9] Plaintiffs state the Congress focused on only one large failure which defrauded customers, whereas defendants maintain it focused on several. Defendants brief on summary judgment, p. 7.

Congressional hearings documented that Golstein Samuelson, Inc. had started business with a thin capital base, and had conducted business by collecting premiums from unsophisticated investors and using these to pay off the customers who exercised their options. The company had obtained few futures contracts to "cover" or "hedge" their obligations because futures contracts are relatively more expensive than the premiums received, and as noted before, the company had little capital above and beyond the premiums received. The company expected to make a profit or the theory few customers would exercise their options because they would have incorrectly guessed market movements, and therefore enough money would be left from customer premiums to repay the few who exercised. Ultimately, when too many customers tried to exercise their options, the company defaulted on its obligations, went bankrupt and many customers were deprived of the benefit of their bargain. Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess., ser. 93-TT, at 181-182, 194-196 (1974); see also Hearings on S. 2485 S. 2578, S. 2837 and H.R. 13113 before the Senate Committee on Agriculture and Forestry, 93d Cong., 2d Sess. pt. 1, at 224-225 pt. 3, at 682-683, 824-25, 830-835 (1974).

[10] House Committee on Agriculture Report on the Commodities Futures Trading Commission Act of 1974, H.R. Rep. No. 975, 93d Cong., 2d Sess. 36-37 (1974).

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ing hearings at which several witnesses testified that options trading might be economically useful and that regulations could be devised to protect option purchases,[11] the House introduced a new bill, H.R. 13113, which authorized the Commission to decide whether to ban or regulate option trading in the newly regulated commodities. This section of H.R. 13113 is substantially the same as that finally enacted into law and reads as follows:

> "No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this Act, but not specifically set forth in section 2(a)(1) of this Act, prior to the enactment of the 'Commodity Futures Trading Commission Act of 1974', which is of the character of, or is commonly known to the trade as, an 'option' 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty', contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission may prescribe: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets."

[11] Hearings on H.R. 11955 before the House Committee on Agriculture, 93d Cong., 2d Sess. at 37, 40-41, 176-180, 199, 251, 329 (1974) see Advisory Committee Report, p. 98.

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The House report on this portion of the bill states:

"Options Trading (Section 402)

The discretionary authority granted the CFTC to regulate or ban trading in options in commodities . . . is not to be exercised by the Commission to approve any transaction of the character of, or commonly known as an 'option', . . . if the option or transaction named does not guarantee the purchase of the futures contract in fulfillment of the option, should the purchaser seek to exercise the option. The Committee intends the Commission act as expeditiously as possible to prohibit such transaction." [12]

The Senate amended this portion of the House bill to require the Commission to prescribe regulations governing options within one year after the effective date of the bill and to clarify the jurisdiction of the Commission relative to that of other regulatory agencies. The Senate otherwise retained the language of the House bill. The Senate Committee report on which the Senate had acted stated:

"The Committee intends that options not be traded except on organized exchanges and in conformity with the rules and regulations of the Commission." [13]

The Conference Committee report does not contain any reference to any limitation on the scope of the Commission's discretion. The Conference substitute embodied the House provision as amended by the Senate with a further amendment which according to the Conference report provided that:

[12] H.R. Rep. No. 975, 93d Cong., 2d Sess. 31 (1974).
[13] S. Rep. No. 1131, 93d Cong., 2d Sess. 36 (1974).

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"The period for issuing regulations governing such options trading may be extended if the Commission determines, and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture, that it will be unable to promulgate such regulations within the one-year period." [14]

Both Houses adopted the Conference substitute which became §4c(b) of the Commodities Exchange Act. Under this statutory provision, option dealers in commodities not regulated prior to 1974 could continue to do business in their accustomed manner until the Commission—by

[14] H.R. Rep. No. 1383, 93d Cong., 2d Sess. 40 (1974). The full text of the Joint Explanatory Statement of the Committee of Conference on this portion of the bill states:

"(16) Options trading.

The House bill continues the ban now contained in section 4c of the Act on trading in options (privileges, indemnities, bids, offers, puts, calls, advance guaranties, and decline guaranties) in the now-regulated commodities, but permits trading in options in all other commodities if not done contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission may prescribe. The Commission could promulgate such an order, rule, or regulation only after notice and opportunity for hearing. The Commission may set different terms and conditions for different markets.

The Senate amendment retains the House provision, but provides that the Commission is to prescribe the regulations governing such options trading within one year after the effective date of the bill.

The Conference substitute adopts the Senate provision with an amendment providing that the period for issuing regulations governing such options trading may be extended if the Commission determines, and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture, that it will be unable to promulgate such regulations within the one-year period."

regulations promulgated after notice and opportunity for hearing—either required them to do otherwise or prohibited trading in options.

History of this Rulemaking

On April 25, 1975 the Commission published its first set of proposed rules pursuant to §4c(b). 40 Fed. Reg. 18187. Termed "antifraud rules", these were designed to prevent deceptive practices in connection with the sale of commodity options. The Commission adopted these in amended form on June 24, 1975 to take effect immediately 40 Fed. Reg. 26504.[15]

On October 22, 1975 the Commission published notice that it was "considering the adoption of further rules to regulate—or perhaps forbid—transactions in commodity options". 40 Fed. Reg. 49360. The regulations ultimately adopted by the Commission pursuant to this rulemaking are those challenged in the instant action. The basis and purpose for considering rules additional to the antifraud rules was stated to be:

> "Commodity-option offerings appear to have proliferated, and many of these offerings appear questionable since in most cases investors are not given adequate assurance that the issuers of the options will be able to perform their obligation under the option contracts when and if required to do so." 40 Fed. Reg. 49360.

[15] The Commission brought an injunctive action to restrain violations of these sections. *Commodities Futures Trading Commission* v. *J.S. Love & Associates Options, Ltd.*, (S.D.N.Y. 1976) ¶20,198, CCH Comm. Fut. L. Rptr. Judge Bonsal denied injunctive relief because there was no likelihood the practices he found to be deceptive would be repeated. See also *Commodities Futures Trading Commission* v. *British American Commodity Options Corp.* (S.D.N.Y. 1976) ¶20,224 CCH Comm. Fut. L. Rptr., J. Gagliardi.

The broad alternatives under consideration included: prohibiting all commodity option transactions, restricting these to contract markets, allowing only those sold in accordance with a "business plan" approved by the Commission and/or allowing only those sold by persons registered with the Commission. The Commission assigned to an Advisory Committee the responsibility of making recommendations to the Commission. 40 Fed. Reg. 49360. This Advisory Committee was composed of fourteen persons. Two were Commissioners of the five-member Commodity Futures Trading Commission.[16] The remaining twelve were mainly from law firms and private industry.[17]

The Commission invited the public to submit comments to both it and the Advisory Committee on these broad alternatives and specific enumerated issues. The concept of segregation was not specifically mentioned at this time. The Commission further stated that pending receipt of the Advisory Committee's recommendations and digestion of public comments it might adopt temporary rules without further public notice should it find these urgently necessary "to protect the public".

After considering the comments submitted in response to its October 22, 1975 notice, the Commission published proposed rules for comment on February 20, 1976. 41 Fed. Reg. 7774.[18] It proposed that all commodity option

[16] John Rainbolt, the Vice-Chairman of the Commission, was Chairman of the Advisory Committee and William Bagley, the Chairman of the Commission, was an ex-officio member of the Advisory Committee.

[17] For biographies of the members of this Advisory Committee, see the Advisory Committee Report, p. 174f.

[18] The Commission had not yet received the report of its Advisory Committee.

dealers be required: to register with the Commission as commodity option dealers, to file a disclosure statement with the Commission and inform each customer such was publicly available at the Commission, and to meet minimum financial standards (that assets exceed liabilities and that "net working capital" exceed $100,000 excluding the premiums received from customers).[19] Commodity option dealers who failed to meet these requirements would be prohibited from trading in options.

However, the Commission stated it would entertain requests for exemptions from the net working capital requirement from those commodity option dealers "who act solely on an agency basis for other dealers who issue or assume full financial responsibility for the commodity option transaction" since it recognized that the requirement "may be inappropriate" for these agent dealers.[20]

The Commission further stated it had decided not to require commodity option dealers to segregate funds received from customers until the option was exercised or expired "because of inherent difficulties of ascertaining which dealer should segregate (i.e., the problem of double segregation)".[21] Nonetheless, the Commission stated it was "particularly interested in receiving comments as to

[19] See 41 Fed. Reg. at 7778 for further definition of the exclusions and inclusions to the net working capital requirement.

[20] Plaintiffs are agents for others who write options on two London exchanges. Plaintiffs have claimed that their principals are required to assume the full financial responsibility for the option transaction.

[21] By this statement the Commission may have meant that in those situations where an option dealer acts as an agent, whose only obligation is to transfer customer premiums to the option writer it might not be appropriate to require such agent to "segregate" the premium he was already obliged to transfer to another.

whether such a requirement could and should be imposed".[22]

In addition the Commission stated that after it received the Advisory Committee report and comments to these proposed rules:

> "the Commission will determine whether it will require additional time to study the recommendations and comments in order to evaluate the extent to which they should be included as part of a permanent regulatory program. If the Commission believes that such additional time is required, the proposed rules may be adopted as interim and temporary rules only." 41 Fed. Reg. 7774.

After publication of these proposed rules, the Commission received many comments, and on March 8, 1976 it held a public hearing. On July 6, 1976 it received the report of its Advisory Committee.

The Chairman of the Advisory Committee, who also was the Vice-Chairman of the Commission, prefaced this report with the question "Commodity Options in the U.S.: What test?" He stated "The statute, itself, is silent." However, he noted that the Act includes standards guiding Commission regulation of *futures* and that:

> "It has been suggested that the Commission apply the same test for options that it applies for futures contracts, *i.e.*, that 'they not be contrary to the public

[22] The Commission also requested comments as to whether it should require option dealers to deliver disclosure statements to prospective customers in advance of any option transaction, and whether it should permit commodity options to be traded on contract exchanges and ultimately restrict option trading to such exchanges.

> interest . . . I suggest the Commission require that proponents of option trading should be prepared to meet requirements and procedures similar to those required by the Commission for futures trading on contract markets which are designated by the Commission." [23]

The Advisory Committee followed the Chairman's suggestions and recommended to the Commission that options dealers should be subject to the same basic requirements that are imposed on futures merchants. One of the requirements it therefore recommended was that options dealers segregate funds received from customers.[24]

The Advisory Committee did not indicate whether or not it had taken into account the circumstance that options dealers—who act as agents and have to forward to their principles funds received from customers—would find this segregation requirement more burdensome than futures dealers who act as principals for their own account. They did, however, state the recommendations were tentative and preliminary since the area of commodity option trading was complex and the data on which the recommendations were based was inadequate.[25]

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[23] Advisory Committee Report, p. xv-xvi. This report was transmitted to the Committee on July 6, 1976 and published as a special supplement to the CCH Commodity Futures Law Reporter on July 15, 1976.

[24] *Id.*, pp. 18, 30, 47-48. The Advisory Committee recommended requiring dealers to segregate that portion of the customer's funds which represented the premium paid for the option right, leaving the dealer free to use that portion representing his costs and commission. It did not suggest specific percentages.

[25] *Id.*, pp. vi, xiii

> "While it is not, and was not intended to be the 'ultimate' study on the subject (which must of necessity await more definitive data), its undertaking was suggested as an *initial* step in dealing with the issues posed by §4c(b) of the Commodities Exchange Act." *Id.*, p. vi . . .
>
> "There are limits to the use of the Advisory Committee forum itself, especially in an area as complex as commodity option trading, where the lack of needed data regarding the subject hampered the Advisory Committee's inquiries." *Id.*, p. xiii.

On October 8, 1976 the Commission published a modified version of its February proposals which it termed "proposed interim regulations" to take effect November 22, 1976. 41 Fed. Reg. 44560. It also invited comment as to whether these should be modified prior to their adoption.

The reason given for adopting these as "interim regulations" was that the Commission planned in 90 days to put into effect a second stage of regulations. The Commission described this proposed second stage as:

> "comprehensive regulations for a limited, rigidly-controlled three-year (or shorter) test program that ultimately will require commodity options to be purchased and sold on or through the facilities of Commission-designated boards of trade . . ."

The Commission further stated:

> "The test program will be designed to determine the nature and extent of the impact of commodity option trading on the underlying futures and cash markets, the economic utility of commodity option trading and the capability of the exchanges to conduct adequate market surveillance and to assure orderly markets . . . the test program will enable the Commission to obtain sufficient data on which to have a permanent regulatory program concerning commodity options or, if necessary, to determine to prohibit trading in

commodity options in the United States." 41 Fed. Reg. at 44560.

Among the interim regulations proposed to take effect in November, 1976 was §32.6 which provided for segregation.[26] In proposing this regulation the Commission recognized that it might cause hardship, especially to those who —like plaintiffs—act as agents for members of London exchanges. Thus the Commission observed:

> "The Commission is aware that proposed § 32.6 may, in certain cases, require 'double segregation.' For example, in the case of the sale of London options, a person receiving the funds from an option customer in the United States as payment for the option may not remit those funds to London in order to obtain or maintain the option position with a London broker. The Commission believes that the proposed segregation requirements are essential customer protection to be afforded commodity option customers in the United States. The Commission recognizes, however, that its proposed segregation requirements may impose a financial hardship on some affected persons." 41 Fed. Reg. 44562.[27]

[26] This proposed regulation provided that the option dealers who were required to register must segregate 100% of the funds received from customers. 41 Fed. Reg. at 44567.

[27] Thus, these Commission rules would require agent option dealers such as plaintiffs to keep the customer's funds segregated in the United States, thereby requiring them, in turn, to obtain additional funds to remit to London in order to obtain the option position.

In addition, we note that plaintiffs have claimed that their principals in turn, are required by the London exchanges of which they are members to segregate all customer premiums so that the agents' customers will be protected. The Commission has disputed this claim, citing the Advisory Committee Report, pp. 41-42, 130-139.

The Commission accordingly requested comments and suggestions for viable alternatives.

After receiving several comments, the Commission published revised rules on November 24, 1976, which are those now under challenge. 41 Fed. Reg. 51808. Insofar as concerns segregation, the Commission revised the amount to be segregated, reducing it from 100% of the funds received from customers to 90% of those funds.[28] Despite this reduction the Commission reiterated its recognition that adoption of this segregation requirement might impose hardship, "particularly with respect to the sale of London options", but simply stated that no acceptable alternative susceptible of immediate implementation had been suggested. Thus the Commission observed:

> "Several commentators have indicated that letters of credit, bonding requirements, and other forms of financial guarantees could be used as alternatives to segregation. While the Commission believes that these suggestions are on the whole constructive, and while the Commission would urge continued efforts by commentators to suggest suitable alternatives to the segregation requirement, specific proposed alternatives have not yet been submitted which would be capable of being effectuated to coincide with the adoption of the interim rules. Accordingly, the Commission has determined to include segregation requirements in the interim rules as adopted. . . ." 41 Fed. Reg. 51812.

The Commission did indicate that it would consider applications for exemption from the segregation requirement,

[28] See the memorandum of the National Association of Commodity Option Dealers in support of the complaint, Exhibit III, for excerpts of the minutes of the Commission's meeting at which the reduction from 100% to 90% was approved.

but made quite clear that it would subject such applications to rigorous scrutiny, and that exemptions would be granted only if "the Commisison finds, in its discretion, that it would not be contrary to the public interest to grant such exemption." 41 Fed. Reg. at 51812.

DISCUSSION

With respect to the regulation requiring segregation, the essential facts are that as first proposed in February, 1976, the rules contained no such requirement. The Commission then specifically noted that such a requirement might well be inappropriate for some option dealers. In July, the Advisory Committee specifically noted that the underlying statute provided no standards to guide its determination. Indicating that it would look for guidance to the standards and methods used in regulating dealers in futures contracts it recommended that option dealers be required to segregate. There is nothing in the Advisory Committee report to suggest that it had considered whether such a requirement—which had originally been devised to apply to dealers in futures contracts who normally act as principals—could be appropriately applied to option dealers who, like plaintiffs, act only as agents.

Acting on the Advisory Committee's report and other comments, the Commission in October for the first time proposed a rule requiring segregation, specifically calling attention to the hardship involved and calling for the suggestion of alternatives. Having rejected all alternatives which were suggested on the ground they were not susceptible of immediate implementation, the Commission in November announced adoption of its interim segregation rule—to take effect December 27, 1976.

The only reason stated for this admittedly harsh action was the need for speed to protect the public. The Commission does not cite, and we cannot find, any reason or fact which had come to its attention since the rules were proposed in February without any provision for segregation which would seem to justify this need for haste.[29] Such haste seems especially unjustified in view of the admittedly harsh consequences of the rule and the Commission's continuing search for alternatives. In the circumstances, we must conclude that plaintiffs have a reasonable likelihood of success in establishing that defendants acted arbitrarily and capriciously in imposing segregation requirements—at least as applicable to option dealers, who, like plaintiffs, act only as agents. See e.g., *National Nutritional Foods Association* v. *Weinberger* (2d Cir. 1975) 512 F.2d 688, 701, *cert. den.* 423 U.S. 827.

Although it has not been claimed that the authority granted the Commission pursuant to §4c(b) constituted an

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[29] Although the Commission appears to justify such haste by adverting to the Congressional directive in §4c(b) that it promulgate rules with respect to options within one year, we note that the Conference Committee amendment which was embodied in the final version of the bill provided an exception to this requirement if the Commission determines and notifies both Houses of Congress "that it is unable to prescribe such terms and conditions within such period." We further note that the Commission did promulgate one set of rules concerning option transactions, the antifraud rules, within the one year period. In addition, on October 8, 1976 the Commission stated: at 41 Fed. Reg. 44560, n.5:

"Section 4c(b) also provides that, if possible, rules were to be adopted within one year after the effective date of the section. However, the Commission advised Congress, in accordance with the provisions of section 4c(b), that it would be unable to meet the one-year time period ending April 21, 1976, within which to have comprehensive commodity option regulations in effect and that additional time would be required to carry out the Congressional mandate contained in section 4c(b)." See 41 FR 16885 (April 21, 1976)

Appendix A

invalid delegation of authority because of the Congress' failure to provide any standards to guide the Commission, we do note that the Commission's Vice-Chairman has specifically observed that the statute is silent on the matter of standards. See p. 13a, *supra*. Whether or not such failure to provide standards could be said to invalidate this portion of the legislation (compare *Panama Refining Company* v. *Ryan* (1936) 293 U.S. 388 and Wright, *Beyond Discretionary Justice*, 81 Yale L.J. 575 (1972) with Davis, *A New Approach to Delegation*, 36 U. Chi. L.R. 713 (1969)), such failure should at least be deemed to impose on the Commission the obligation of taking particular pains to ensure that its rulemaking will not be arbitrary and capricious. See Davis *op. cit., supra*.

Therefore, with respect to the regulation requiring segregation, it is our conclusion of fact that plaintiffs are threatened with irreparable injury in that, being required by the necessities of their business to forward to their principals in London the premiums for options they sell to their customers (representing at least 75% of the funds received from customers), they could not long remain in business if required to segregate in the United States an amount equal to 90% of such funds.[29a] It is our conclusion of law that—for the reasons above outlined—plaintiffs have a reasonable likelihood of success on the merits of their attack on the segregation requirement. We further conclude, in light of the wide panoply of regulations already and about to be in effect, that the public interest will not be adversely affected by preliminarily enjoining these segregation requirements.

[29a] The Commission's suggestion that this could be accomplished by bank financing is not persuasive.

Appendix A

In addition to the above discussed claim with respect to segregation, plaintiffs British American and Lloyd, Carr put forth a wide variety of contentions as follows:

1. defendants violated the Administrative Procedure Act (A.P.A.) 5 U.S.C. §553 by failing to give an opportunity for meaningful public comment on the rules published November 24, 1976 and by publishing a portion of these rules to be effective in less than 30 days without good cause.
2. defendants' actions are unsupported by substantial evidence in violation of 5 U.S.C. §706(E).
3. the minimum financial and the disclosure requirements adopted are arbitrary and capricious in violation of 5 U.S.C. §706(2)(A).
4. the defendants acted in excess of their statutory jurisdiction under the Commodities Exchange Act §15 7 U.S.C. §19 in that the regulations promulgated are anti-competitive.
5. the defendants acted "without due process as guaranteed by the Fifth and the Fourteenth Amendments to the Constitution since the defendants are not authorized to put the plaintiffs out of business through the imposition of rules".[30]

We find none of these to have merit.

With respect to the claim that defendants violated the Administrative Procedure Act, 5 U.S.C. §553 by promulgating rules November 24, 1976 which allegedly were substantially different from earlier rules without having given the public the opportunity for meaningful comment there-

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[30] Amended Complaint ¶8b, p. 4.

on, we find the Commission provided adequate notice of each of the provisions now contained in its rules and adequate opportunity to comment thereon. To meet this section of the A.P.A., which requires the agency to give notice of proposed rules and to give interested persons an opportunity to participate in the rulemaking, it is sufficient that the proposed rules to which comments are addressed give reasonable notice of the subjects and issues. The Administrative Procedure Act does not require that the rules adopted be identical to those proposed. *California Citizens Band Association* v. *United States* (9th Cir. 1967) 375 F.2d 43.

With respect to the claimed violation of §553(d)—in that a portion of the Commission's rules published November 24, 1975 were to take effect less than 30 days thereafter, we find the Commission adequately stated and published good cause for its action.[31] Thus, it met the terms of the exception to the requirement of 30-day publication found in subsection (3) of §553(d).[32]

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[31] The Commission stated:

"The Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been fraught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof." 41 Fed. Reg. at 51817. See also 41 Fed. Reg. at 51810, column 1.

[32] In fact, most of the changes relieved prior proposed restrictions, thus meeting the terms of another exception to 30-day publication, that stated in subsection (1) of §553(d).

Plaintiffs' claim that defendants' actions are unsupported by substantial evidence cannot be considered. 5 U.S.C. §706(E) makes it clear this standard of review is applicable only to rulemakings pursuant to 5 U.S.C. §556 and §557. The rulemaking here involved was not required to be conducted pursuant to those sections of the Administrative Procedure Act since the Commodities Exchange Act §4c(b) does not require these hearings to be "on the record." Section 4c(b) of the Act requires only that regulations concerning options be made "after notice and opportunity for hearing."

One of the attacks upon the minimum financial requirements as arbitrary and capricious rests on the theory that the segregation requirements will unduly deplete plaintiffs' assets and thus prevent them from meeting the minimum financial requirements. That argument has been disposed of by our ruling with respect to segregation. At oral argument we were persuaded that the other arguments against the minimum financial requirements were grounded upon a misunderstanding of the Commission's regulations.

The claim that the disclosure requirements are arbitrary and capricious also rests on plaintiffs' erroneous reading of the regulations. We accept the Commission's representation at oral argument that plaintiffs are not required to specify the exact results of currency fluctuations and other items not susceptible of knowledge at the time of a sale, but are required only to list and explain such uncertainties. In connection with price items, the requirement is to explain the elements and the method of calculation. The disclosure requirements otherwise appear to us to not be arbitrary or discriminatory.

The claim that the Commission failed to adopt the least anti-competitive means and that this violates the Commod-

ities Exchange Act §15, 7 U.S.C. §19 (Supp. V, 1975) raises no question for us to review. The section cited does not require the Commission to adopt the least anti-competitive means, but only requires it to

> "*take into consideration* the public interest to be protected by the antitrust laws *and endeavor to take* the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation . . ." (emphasis supplied).

Plaintiffs have shown us no reason to challenge the Commission's statement that it did consider the anti-competitive impact of various alternatives. 41 Fed. Reg. 51809.

In view of our decision with respect to the segregation requirements, the claim that defendants acted without due process "since the defendants are not authorized to put the plaintiffs out of business through the imposition of rules" can be dismissed since plaintiffs are not in danger of being put out of business.[33]

In addition to the claims made by the original plaintiffs the National Association of Commodity Option Dealers has claimed that the requirement that *option dealers* register as "futures commission merchants" is in excess of statutory authority because the Commodities Exchange Act specifically defines futures commission merchants as "individuals . . . engaged in . . . [the] sale of any commodity for future delivery on or subject to the rules of a contract

[33] In addition, we note that §4c(b) of the Commodities Exchange Act does authorize the defendants to prohibit trading in options provided the defendants act by rule or order after notice and opportunity for hearing.

market. . . ." [34] The Commission has itself answered this in the Federal Register notice of November 24, 1976:

> "One commentator suggested that the Commission's determination to make it unlawful for persons to accept money and other funds from option customers unless registered as futures commission merchants was, in effect, an amendment of the Act's definition of a futures commission merchant. The Commission disagrees. Persons who come within the definition of futures commission merchant in section 2(a)(1) of the Act are required to register as such thereunder. The Commission's adoption of the interim rules in no way alters that obligation and in no way alters the definition of futures commission merchant contained in the Act. Rather, as the Commission stated at the time of its October 8, 1976 proposal, the Commission has determined, pursuant to its plenary power to regulate commodity option transactions, to entrust options activities only to persons who meet the basic financial and other requirements of futures commission merchants and associated persons of specified futures commission merchants under the provisions of the Act and the regulations promulgated thereunder."

We think this adequately disposes of the argument.

[34] Section 2(a)(1) of the Commodities Exchange Act, 7 U.S.C. §2. We note that the Commission has previously taken the position that other provisions of the Commodities Exchange Act which use the language "commodities for future delivery on or subject to the rules of a contract market", for example §4b, "may not apply to option transactions since these transactions are not made 'on or subject to the rules of any contract market.'" 40 Fed. Reg. 18188 (April 25, 1975).

CONCLUSION

On the basis of the foregoing we deny plaintiffs' motion for a preliminary injunction except as it applies to that portion of its rules requiring segregation (§32.6). With respect to that requirement, the defendants are preliminarily enjoined from enforcing it against any plaintiff who is in the business of selling options as an agent.

The defendants' motion for summary judgment is denied with respect to the said requirement of segregation, and is otherwise granted.

Settle order on notice.

Dated: New York, New York
December 21, 1976.

WHITMAN KNAPP,
U.S.D.J.

Appendix B

(Order and Judgment)

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

[CAPTION OMITTED]

This cause came on for hearing on December 10, 1976, on plaintiffs' motion for an order preliminarily enjoining the defendants, who are the members of the Commodity Futures Trading Commission, from implementing or enforcing regulations relating to commodity option transactions published in the Federal Register on November 24, 1976, and on the defendants' cross-motion for summary judgment, pursuant to Rule 56 of the Federal Rules of Civil Procedure. The Court having heard the argument of counsel and having considered the affidavits, exhibits and legal memoranda in support of the motions and in opposition thereto and all other papers heretofore filed in the case, and due deliberation having been had thereon, it is hereby

ORDERED, that the defendants, their officers, agents, servants, employees and attorneys, and those persons in active concert or participation with them who receive actual notice of this order, be and they hereby are preliminarily enjoined, during the pendency of this action, from enforcing the segregation requirements contained in Section 32.6 of said regulations against any plaintiff who is in the business of selling options as an agent for a principal; and it is further

Appendix B

ORDERED that defendants' motion for summary judgment is in all respects granted except with respect to the segregation requirements set forth in Section 32.6 of said regulations, and, there being no just reason for delay, judgment is hereby directed to be entered in favor of the defendants on all issues other than the enforcement of Section 32.6.

Dated: January 3, 1977
New York, N.Y.

WHITMAN KNAPP,
U.S.D.J.

Appendix C

(Opinion of Court of Appeals)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 863, 864, 865—September Term, 1976.

(Argued February 9, 1977 Decided April 4, 1977.)

Docket Nos. 77-6010, 77-6011, 77-6019

BRITISH AMERICAN COMMODITY OPTIONS CORP. and LLOYD, CARR & Co.,

Plaintiffs-Appellants-Cross Appellees,

—against—

WILLIAM T. BAGLEY, Chairman of the Commodity Futures Trading Commission, et al.,

Defendants-Appellees-Cross Appellants.

NATIONAL ASSOCIATION OF COMMODITY OPTIONS DEALERS, et al.,

Plaintiffs-Appellants-Cross Appellees,

—against—

THE COMMODITY FUTURES TRADING COMMISSION, et al.,

Defendants-Appellees-Cross Appellants.

Appendix C

Before:

FEINBERG, GURFEIN and MESKILL,
Circuit Judges.

Appeal from order of the United States District Court for the Southern District of New York, Whitman Knapp, *J.*, granting a preliminary injunction against regulation requiring dealers to segregate customer funds, but in other respects granting summary judgment against challenges to regulations of commodity options trading.

Affirmed in part and reversed in part.

CHARLES J. HECHT, New York, N. Y. (Haig Costikyan, David Greene, Martin Kaplan, Gusrae, Greene & Kaplan, on the brief), *for Plaintiffs-Appellants-Cross Appellees British American Commodity Options Corporation and Lloyd, Carr & Co.*

LEONARD R. GOLDSTEIN, College Park, Maryland, *for Plaintiffs - Appellants - Cross Appellees National Association of Commodity Options Dealers, Bristol Options, Inc., Chartered Systems Corporation, Cleary Trading Company, Inc., First New York Commodity Options, Inc. of Los Angeles, Williston Corporation and International Commodity Options, Ltd.*

FREDERIC T. SPINDEL, Washington, D.C. (Richard E. Nathan, Acting General Counsel, Commodity Futures Trading Commission, and Virginia F. Crisman, on the brief), *for*

Appendix C

Defendants-Appellees-Cross Appellants The Commodity Futures Trading Commission, William T. Bagley, John V. Rainbolt II, Gary Seevers, Read P. Dunn and Robert L. Martin.

FEINBERG, *Circuit Judge:*

Nine commodity options dealers and the National Association of Commodity Option Dealers (NASCOD) in this consolidated action challenge new rules that regulate the commodity options industry. The Commodity Futures Trading Commission (Commission) promulgated the rules under authority granted in 1974 by the Commodity Futures Trading Commission Act, Pub. L. 93-463, 88 Stat. 1389, 7 U.S.C. §§ 1-22 (Supp. V, 1975). Plaintiffs claim that the regulatory scheme violates various requirements of the Administrative Procedure Act, 5 U.S.C. §§ 551 et seq. (1970), and the United States Constitution. Prior to the effective dates of the new rules, plaintiffs brought suit in the federal courts[1] for declartory relief, and moved for a preliminary injunction against implementation of the rules. With the certified record of the informal rule making proceeding before him, Judge Whitman Knapp of

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[1] Plaintiffs British American Commodity Options Corp. and Lloyd, Carr & Co. sued in the United States District Court for the Southern District of New York on November 15, 1976, No. 76 Civ. 5124. NASCOD and other plaintiffs filed initially in the United States Court for the District of Columbia, No. 76 Civ. 2250. Upon learning that the same issues had been presented in New York, the plaintiffs in the D.C. action appeared in New York on December 10, 1976 and argued the motions that led to the instant appeal. The D.C. district court granted a change of venue four days later, and Judge Knapp in New York granted a motion to consolidate the two actions.

the United States District Court for the Southern District of New York enjoined the regulation that required segregation of customers' funds, but otherwise denied plaintiffs' motion and granted summary judgment for the Commission. We reverse the injunction against the segregation rule, and in other respects affirm the judgment of the district court.

I

The Commodity Options Industry

The commodities business operates as a marketplace of contracts. The contracts traded are for the purchase, or sale, of specific amounts of a commodity[2] either that have already been produced, or that will be produced in the future and delivered by a specific date. This latter group of contracts are known as "commodity futures." [3]

[2] The Commodity Futures Trading Commission Act, 7 U.S.C. § 2 (Supp. V, 1975), defines "commodity" as

> wheat, cotton, rice, corn, oats, barley, rye, flax-seed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes) wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in . . . .

[3] For general descriptions of the market's operation, see R. Teweles, C. Harlow & H. Stone, The Commodity Futures Game (1974); Horn, Commodities, in The Stock Market Handbook 307-15 (F. Zarb & G. Kerekes eds. 1970). See also Johnson, The Perimeters of Regulatory Jurisdiction under the Commodity Futures Trading Commission Act, 25 Drake L. Rev. 61 (1975), which describes the shift in emphasis of commodity regulation from farm interests to investor protection, and Smith, Commodity Futures Trading, 25 Drake L. Rev. 1 (1975).

A "commodity option" is a contractual right to buy, or sell, a commodity or commodity future by some specific date at a specified, fixed price, known as the "striking price." [4] A contract entitling its owner to purchase the commodity is known as a "call," and a contract entitling its owner to sell is called a "put." In the plainest case, an option is created, or "written," by the owner of a commodity or commodity futures contract, who commits himself to sell his goods or contract. But an option can also be written by anyone else willing to take the chance that he will be able to cover his obligation in the futures market, if the option purchaser decides to exercise the option. Such an option is described as "naked."

The plaintiff firms in this case deal in "London options," which are options on futures contracts for certain commodities that are traded in London, England, on either the London Metals Exchange (LME) or several other exchanges whose transactions are cleared through the International Commodity Clearing House (ICCH). The plaintiff firms sell London options in the United States and, according to plaintiffs British American Commodity Options Corp. and Lloyd, Carr & Co., operate as follows: Plaintiffs actively solicit customers through direct mail and telephone contacts, as well as by newspaper and television advertising. When a customer orders the purchase of a commodity option, the dealer furnishes him with a notice giving the details of the transaction including the nature of the underlying futures contract, the price the writer charges for the option, known as the "premium," the dealer's commission, and the market on which the trade

[4] For a fuller description of commodity futures options and their uses as investment tools, see S. Kroll & I. Shisko, The Commodity Futures Market Guide 258-68 (1973).

will be executed. The customer may or may not have paid for the option when this notice is sent; only payment of the purchase price to the dealer commits the customer to buying the option. The price quoted in the notice is firm, however, for five days, which means that the dealer assumes the risk of a price increase during that period. Once the dealer receives cash payment, he executes the trade through a "clearing member" of one of the English exchanges. The dealer then immediately forwards the premium amount to the clearing member, who pays the option writer. At the same time, the dealer sends another notice to the customer giving final details of the transaction.[5]

To profit from this purchase, the customer must exercise the option before it expires. Exercising the option means buying the underlying futures contract. Since the customer normally has no interest in actually receiving the commodity on the delivery date, the clearing member then sells a futures contract short for the customer. The difference between the price at which the option is exercised plus the cost of purchasing the option (premium and commission) and the price at which the futures contract is sold is the customer's profit. If, however, the market price for the futures contract has dropped below the striking price, the customer allows the option to expire, in which case he loses his entire investment.

Market Regulation

Intimations of difficulties in the commodity options market came to the attention of Congress in the early 1970's; existing laws had not worked well in preventing

[5] See Long, Commodity Options—Revisited, 25 Drake L. Rev. 75, 111-128 (1975), for an excellent description of the London options market and the sale of London options in the United States.

abuses in the options industry.[6] Options were an especially hospitable environment for abuse because a naked option could be created out of nothing, if the writer was willing to run the risk of not covering his obligation by acquiring an offsetting position in the futures market. Thus, entry into the business of options required little capital. In addition, options bear lower price tags than the futures contracts underlying them, so the options market may be peculiarly attractive to individual investors of relatively modest means and with a propensity for taking risks.

Before 1974, regulation of trading in commodity futures and options derived mainly from the Commodity Exchange Act, 7 U.S.C. §§ 1-17b (1970).[7] That Act empowered the Commodity Exchange Authority of the Department of Agriculture to administer certain limited regulations on trading in a number of agricultural commodities,[8] and completely banned options on them. 7 U.S.C. § 6c (1970). On October 23, 1974, Congress enacted the Commodity Futures Trading Commission Act, supra, which created the Commission as an independent regulatory agency with

[6] H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 36-53 (1974).

[7] Attempts to invoke the securities laws in this context have met with only mixed success. Compare *Continental Marketing Corp.* v. *SEC*, 387 F.2d 466 (10th Cir. 1967), with *Glazer* v. *National Commodity Research and Statistical Service, Inc.*, No. 74-1861 (7th Cir., filed Jan. 7, 1977). See generally 1 A. Bromberg, Securities Law: Fraud 82.241-69 (1975); Long, supra note 5.

[8] 7 U.S.C. § 2 (1970) provided, in pertinent part:

> The word "commodity" shall mean wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice.

plenary rulemaking power. The Act also substantially broadened the field of regulation, to include virtually all "goods and articles," see note 2, supra.[9] The Commission was given

> exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery.

7 U.S.C. §2 (Supp. V, 1975).

The new Act perpetuated the old Act's absolute ban on option trading for the commodities listed in the old Act, 7 U.S.C. § 6c(a) (Supp. V, 1975), but permitted other options to be written and to trade in compliance with rules promulgated by the Commission. 7 U.S.C. § 6c(b) (Supp. V, 1975). The Act authorized the Commission "to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this chapter." 7 U.S.C. § 12a(5) (Supp. V, 1975).

On April 25, 1975, soon after the Commission came into official existence, it published for public comment a proposed anti-fraud rule, 40 Fed. Reg. 18187 (1975), that broadly proscribed fraudulent and deceptive practices and the making of false statements in connection with commodity options transactions. The anti-fraud rule became effective June 24, 1975. The Commission explained that its swift action was necessary because the Act's grant of exclusive jurisdiction to the Commission had left the public without regulatory protection.

[9] Onions were excepted, in accordance with Pub. L. 85-839, 72 Stat. 1013 (1958), which prohibited all trading in onion futures. Congress took this action after onion producers reported that price variations in the futures market had been adversely affecting the cash price of onions. See S. Rep. No. 1631, 85th Cong., 2d Sess. (1958); H.R.Rep. 1036, 85th Cong., 1st Sess. (1957), reprinted in [1958] U.S. Cong. Code & Admin. News 4210-4215.

In October 1975, the Commission announced that it was considering rules to regulate or prohibit all options trading. The Commission also announced the appointment of an Advisory Committee on the Definition and Regulation of Market Instruments[10] to study the options situation and recommend suitable regulations. The public notice solicited suggestions of temporary rules to be adopted, and offered for consideration a number of alternative approaches: prohibition of all community options transactions; restricting options trading to established contract markets; allowing trading only of options written as part of a Commission-approved "business plan"; prohibition of "naked" options; or registration by the Commission of dealers who comply with certain Commission fiduciary requirements. 40 Fed. Reg. 49360-62 (1975). The Commission did receive some comments from the public, although apparently none from any plaintiff.

On February 20, 1976, the Commission published its proposed temporary rules to govern commodity options transactions. 41 Fed. Reg. 7774 (1976). The proposal

[10] The Committee was composed of seventeen members. It included various industry leaders, exchange officials, economists, attorneys, the Illinois securities commissioner, a farmer-rancher, a consumer representative, and two members of the Commission, one of whom served as the Committee's chairman.

called for all options dealers, among other things, to register with the Commission, to maintain at least $100,000 of working capital, to keep certain records, and to disclose to options customers that certain information about the options dealer could be obtained from the Commission. Notably absent from the proposal was any requirement that the dealer set aside, or "segregate," any portion of the customer's cash payment until the option is sold or exercised. The Commission did, however, indicate that it was "particularly interested" in comments on the wisdom of such a requirement. 41 Fed. Reg. 7776 (1976).

At an oral hearing in March 1976, the Commission received the views of various witnesses, including counsel for British American. The Commission also received written comments, some supporting segregation, and in July 1976, the Advisory Committee transmitted its report, which also supported segregation.

On October 8, 1976, the Commission published proposed interim regulations, intended to become effective on November 22. Written comments from the public were invited on or before November 8. British American submitted comments and requested oral hearings, which the Commission did not provide. The Commission adopted the regulations, substantially in the form it had proposed, on schedule and gave public notice on November 24, 41 Fed. Reg. 51808 (1976), but delayed effectiveness for 15 days, except that the segregation requirement was delayed 30 days.

The new rules forbid an option dealer to do business after January 17, 1977 unless he is registered as a "futures commission merchant" (FCM) under the Act. 17 C.F.R. § 32.3 (1976). To be registered, a dealer has to comply with a new minimum capital requirement, 17 C.F.R. § 1.17 (1976), that the dealer maintain adjusted working capital in

excess of the greater of $50,000 or a formula figure, one of whose components is five percent of the dealer's aggregate indebtedness. The new disclosure rule, 17 C.F.R. § 32.5 (1976), requires the option customer to be furnished a "summary disclosure statement" prior to the commodity option transaction. The statement must contain, among other things, a brief description of the "total quantity and quality" of the commodity under the option, its duration, the elements comprising its purchase price, the method by which the striking price is established, the amount of the commission to be charged, a statement that the price rise (for a call) or price fall (for a put) must exceed the premium amount plus costs in order for the option customer to make money, and a clear explanation of the possible effects of currency fluctuations on options executed through foreign facilities. Section 32.6 of the new regulations requires an FCM to segregate 90 percent of the payment received from the customer in a United States bank account until expiration or exercise of the option. Also, the rules require an FCM to keep pertinent records of each transaction. 17 C.F.R. § 32.7 (1976).

The new rules announced on November 24 differed in several respects from the October 8 version. In addition to postponing the effective dates, as indicated above, the new rules relaxed the earlier proposed requirement that the summary disclosure statement be furnished no less than 24 hours before the transaction. The Commission changed this requirement to allow the statement to be furnished merely "prior" to the transaction, because of public comments that the proposed rule was unrealistic in light of the volatile nature of the commodities markets. In addition, the new rules change the requirement that particularized price information be disclosed before rather

than after the transaction. And the amount to be segregated was reduced from 100 percent to 90 percent so that an FCM could immediately get funds for commissions, salaries, and administrative expenses. See 41 Fed. Reg. 51811-13 (1976).

As indicated above, plaintiffs' efforts in the district court to enjoin operation of the new rules were unsuccessful, except for the segregation requirement. Except for that portion of the order, plaintiffs urge us to reverse the judgment of the district court. The Commission cross-appeals and seeks reversal of the injunction against the segregation requirement.

II

Procedural Claims

Plaintiffs claim that the regulations were adopted in violation of the rulemaking notice provision of the Administrative Procedure Act, 5 U.S.C. § 553 (1970). The regulatory scheme was published in final form only 15 days before most of it became effective. Plaintiffs argue that this waiting period was impermissibly short under § 553(d), which provides that "the required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except . . . (3) as otherwise provided by the agency for good cause found and published with the rule." The statutory hiatus, plaintiffs assert, allows interested parties a chance to participate meaningfully in the rulemaking process, and enables the agency to educate itself properly. Where, as here, both the system of rules and the agency itself are newly created, this rationale is particularly compelling. Moreover, two plaintiffs charge the Commission with purposeful evasion of the procedural requirement. They claim that the November 24 publication

came as a direct response to their November 15 filing of a complaint against the rules in the federal district court, and that since the Commission had indicated that oral hearings on the October 8 proposal would be held sometime in December, the Commission thus actively deterred the firms from participating in the rulemaking process during October and early November. Finally, plaintiffs appear to claim that in any event some sort of oral hearing before the Commission after October 8 was required before the new rules could be issued.

Fairly characterized, however, the Commission's procedures adequately complied with statutory requirements and did no substantial injustice to the plaintiffs. The Commission first published notice of its plan to promulgate regulations in October 1975. The first specific proposal was released on February 20, 1976, and in March oral hearings were held. After consideration of the views there expressed and of the report of the Advisory Committee, the Commission on October 8, 1976 announced its revised proposal, which was finally adopted in substantially the form then proposed. Notwithstanding the language of § 402 of the new Act, 7 U.S.C. § 6c(b), which provides that "any . . . order, rule, or regulation may be made only after notice and opportunity for hearing," no oral hearing was required after October 8. *United States* v. *Florida East Coast Ry. Co.*, 410 U.S. 224 (1973). Nor did the Commission announce that there would be one, as some of the plaintiffs imply. With respect to the time period, plaintiffs appear to argue that the changes between the October 1976 proposal and the final rules announced on November 24 were sufficient to trigger a new 30-day wait. We doubt this, see *Chrysler Corp.* v. *Department of Transportation*, 515 F.2d 1053, 1061 (6th Cir. 1975); *California Citizens Band As-*

sociation v. *United States,* 375 F.2d 43, 48-49 (9th Cir. 1967), and we note that all the changes appear to have relaxed the requirements for the plaintiff firms. But in any event, the Commission was not required to delay effectiveness another 30 days if "good cause" for acceleration was "found and published with the rule." The November 24 announcement declared the following:

> In order to assure full and fair consideration of the various proposals that have been made over the many months in which option regulations have been considered, it has not been possible to implement appropriate regulations before now. That consideration having now been completed, however, the Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been braught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof.

We agree with Judge Knapp that this statement was adequate to satisfy the requirement of § 553, especially since plaintiffs have made no showing of prejudice to them from the 15-day acceleration of the effective date of the

new rules. They had ample time both to participate in the rulemaking process and to ready themselves to comply with the rules whose effective date the Commission accelerated. And the segregation requirement, about which plaintiffs complain the most, was delayed for 30 days after November 24.

Segregation

As already indicated, Judge Knapp granted a preliminary injunction against the new segregation requirement. 17 C.F.R. § 32.6 (1976). That section requires that 90 percent of the customer's money be retained in an American account until performance under the option contract is complete. But the London exchanges, which allegedly maintain their own systems of customer safeguards, must simultaneously be sent that portion of the customer's money that represents the premium amount. Thus, the American options dealer must himself have the funds to place a major portion of the price of the option he sells in a segregated account. British American estimates that this "double segregation" burden will require it to raise several million dollars in capital, which may be impossible for it. Moreover, plaintiffs argue, such strangulation of the industry is manifestly unnecessary in light of the London exchanges' own system of financial safeguards.

The Commission was not unmindful of these considerations. The October 8, 1976 notice took account of the possibility of heavy capital demands on dealers in London options, and invited suggestions of alternatives. But the Commission stressed then, and repeated in the November 24 publication of the rules as adopted, that its primary purpose was to protect customers' money from the sort of

abuses that have plagued the field.[11] The Commission looked warily at safeguards allegedly implemented abroad, noting that "assets [segregated in the United States] will not be subject to the attachment or other laws or requirements of any other nation." 41 Fed. Reg. 44564 (1976). Evidence in the record raised serious questions about whether the English safeguards would effectively protect the American customer. At the Commission's March 1976 oral hearing, counsel for British American in effect conceded that the London guarantees do not run to options customers in the United States. Moreover, stringent controls on the use of customers' money are particularly sensible in an industry, such as commodity options trading, that attracts some thinly capitalized firms. In the absence of such protection, a need for capital might prod a dealer into over-dependence on customers' money to finance general operations. In that event, if some difficulty should arise in the chain of transactions needed to generate a profit for the customer seeking to exercise his option, he might be left without a readily available source for recoupment of his investment. Thus, the very point plaintiffs raise to challenge the wisdom of requiring domestic segregation—their financial vulnerability—argues strongly for the requirement. And the Commission has pointed out that financially stable firms may be able to meet the capital demands of segregation by borrowing, and using the interest they can obtain on the segregated funds to defray a good part of the cost of borrowing.

Judge Knapp noted that the scheme of regulations as originally proposed in February 1976 had no segregation

[11] See, e.g., *SEC* v. *Continental Commodities Corporation*, 497 F.2d 516 (5th Cir. 1974); *SEC* v. *Univest, Inc.*, 405 F. Supp. 1057 (N.D. Ill. 1976). See also H.R. Rep. No 93-975, supra note 6.

requirement, and he saw no reason for its hasty addition. He concluded that the preliminary injunction would not adversely affect the public interest, and that "plaintiffs have a reasonable likelihood of success in establishing that defendants acted arbitrarily and capriciously in imposing segregation requirements."[12] He looked to the prospect that the plaintiff firms "could not long remain in business" if required to segregate as one indication that the requirement might be unreasonable.

On the basis of the Commission's justifications and the record before us, we disagree with the district court that the segregation requirement should be enjoined. The Commission's conclusion that in light of past abuses, the public now needs this minimal protection carries great weight. And in any event, the requirement is not unreasonable even if it threatens to restrict participation in the industry to soundly capialized firms.[13] Nor does it appear that the Commission adopted the requirement with undue haste. The Commission first publicly raised the possibility of segregation in October 1975, although at that time no regulations were put forward. The February 20, 1976 notice again broached the subject. 41 Fed. Reg. 7776. Although the proposed rules published then did not call for segregation, the Commission did request comments on the idea, and in July 1976, the Advisory Committee publicly recommended segregation. Furthermore, the February 1976 proposal had more stringent net capital requirements

[12] We agree with Judge Knapp that the proper test to apply was the arbitrary and capricious standard of 5 U.S.C. § 706(2)(A). *National Nutritional Foods Association* v. *Weinberger*, 512 F.2d 668, 700-01 (2d Cir.), cert. denied, 423 U.S. 827 (1975).

[13] Indeed, the rulemaking power vested in the Commission by Congress allows the possibility that the Commission might ban options transactions altogether. 7 U.S.C. § 6c(b) (Supp. V, 1975).

and apparently compelled the dealer to maintain in the United States assets sufficient to cover not only its customers' investments but also even the unrealized gains on the customers' options. 41 Fed. Reg. 7783-84 (1976).[14] When in October 1976 the Commission's new proposal relaxed the net capital requirements, the segregation rule that replaced it was by no means a complete surprise. The Commission had, with the aid of public participation, been considering it for almost a full year. Nor did the Commission's examination of the segregation rule cease with publication of the October 8 proposal. That version required 100 percent segregation, but the Commission reduced that figure to 90 percent in the final rule.

We conclude, therefore, that the Commission's decision to impose a segregation requirement was a reasonable exercise of its discretion in an effort to protect the public, and that the Commission's analysis of the problem and alternative solutions was adequately deliberate. We hold that the district judge erred in granting plaintiffs a preliminary injunction against the segregation requirement.

Registration

Under 17 C.F.R. § 32.3 (1976), all commodity options dealers must register with the Commission by January 17, 1977. Plaintiffs attack the requirement on several grounds:

[14] The February proposal required the dealer to maintain $100,000 in net working capital. Moreover, the proposal required computation of net working capital as of the close of each business day, in accordance with a prescribed method designed to take into account the exposure that a commodity option dealer might experience "should the market move against the dealer and in favor of a purchaser." See 41 Fed. Reg. 7778 (1976). This approach was tailored to a market in which a dealer was allowed to both write and sell options. By October, the Commission had decided against allowing dealers to write options. 41 Fed. Reg. 44560 (1976).

(1) the Commission's position that it could not assure applicants that their filings would be processed by the deadline unless filed by December 27 was unreasonable because Judge Knapp only upheld the regulations on December 21; (2) the regulation's structure—requiring registration by January 17, 1977 rather than filing—vests the Commission with unbridled discretion to exclude any applicant from the options business simply by not acting on the application for registration; (3) section 32.3 conflicts diametrically with 17 C.F.R. § 1.19 (1976): the former requires options dealers to register as FCM's, and the latter section forbids FCM's to "make, underwrite, issue, or otherwise assume any financial responsibility for the fulfillment of, any [option transaction]."

Plaintiffs' first two arguments are in essence that the Commission acted high-handedly in proclaiming the January 17 deadline. Especially since the agency confronted a previously unregulated field, plaintiffs stress, it should have made conscientious efforts to avoid unnecessarily disrupting the industry. We agree that the laudable intent to protect the public cannot give regulators unbridled freedom to do as they wish. Viewing the Commission's conduct here as a whole, however, we do not believe that there was substantial injustice or gratuitous disruption. Plaintiffs did have reasonable advance notice that registration would be required and could not rely on the possible success of their lawsuit as an excuse for not being prepared to file. Moreover, the Commission has not dragged its feet on the applications filed. After oral argument, the Commission advised us by letter that it had not yet acted on the filings of only two of the plaintiff firms, both of which had filed during January. Three other plaintiffs remain unregistered, but they are the subjects of administrative proceed-

ings brought by the Commission to determine whether registration should be refused. Under the circumstances, the attack on the registration requirement must fail.

Similarly, there is no merit to the argument that § 32.3 may conflict with § 1.19 and thereby, in effect, preclude plaintiffs from engaging in the commodity option business. The American firms dealing in London options operate solely as agents, a role the Commission has not deemed to constitute an assumption of "financial responsibility" barred by § 1.19. British American and Lloyd, Carr urge that the Commission "can always take the position that since the retail London commodity options dealers are responsible for transmitting customer funds to and from London they 'otherwise assume financial responsibility,' " [15] thereby violating § 1.19. However, as long as the Commission construes its own regulations consistently, plaintiffs' claim is devoid of merit. If the Commission acts inconsistently—and we do not assume or suggest that it will—plaintiffs have shown that they know how to go to court to protect their rights.

Disclosure

Implementation of the disclosure requirements in the new regulations correlates with a decline in options sales for plaintiffs. For example, British American tells us that its gross options premiums per month dropped from $2,238,748 in November 1976 to less than $1 million in December. Net income from options simultaneously fell off sharply. British American attributes this decline to the Commission's "severe" and "punitive" requirements which seriously disadvantage options dealers in competition with

[15] Brief of appellants British American and Lloyd, Carr at 40.

dealers of futures contracts or stock options. They further argue that it is unfair not to make the requirements also applicable to traders only of futures since the customer takes a greater risk in a futures transaction: A futures customer may be subject to margin calls, whereas the commodity options customer, who pays the full premium in cash, cannot be.

We do not doubt that full disclosure of commissions and fees and a clear statement of what must happen before the customer makes money from his option cool the public's ardor for options. But the Commission concluded that such disclosure is an effective way to help the public make informed investment decisions. We cannot say that this judgment was arbitrary or irrational. Indeed, it seems sensible; the very fact that the disclosures have so drastically affected plaintiffs' business supports the Commission's position. As for the comparative leniency of disclosure requirements for futures and stock options,[16] the Commission was entitled to rely on the added supervision of those markets,[17] and the extensive disclosures required from the issuers of the securities that underly stock options.

Minimum Financial Requirements

Plaintiffs also attack the minimum capital requirement for FCM's, 17 C.F.R. § 1.17 (1976), as arbitrary, capricious, and unreasonable. Plaintiffs complain that the $50,000

[16] Stock options trading is regulated by the Securities and Exchange Commission, not by the Commodity Futures Trading Commission.

[17] For a summary of regulation of futures trading and commodity futures exchange activities under the new Act, see Smith, supra, note 3 at 33-44.

minimum is arbitrarily pegged at five times the minimum requirement for commodity futures dealers, even though futures trading involves much greater sums of money than options trading. Furthermore, plaintiffs argue, the definition of "aggregate indebtedness" in § 1.17 pits the dealer's interest against that of his clients by requiring the dealer "to take a 5% 'haircut' on customers' equity." [18] By this plaintiffs mean that as the value of a customer's option goes up (if that happens), the dealer's indebtedness to the customer is deemed to rise simultaneously so the dealer must augment his working capital by 5 percent of the increase.

With respect to the $50,000 minimum, the Commission explained in its November 24 notice: "Based on its experience, . . . the Commission believes that the distinction in working capital requirements between futures commission merchants who are engaged in options activity as opposed to those who are not, is necessary to provide a cushion against losses which are more likely to arise in the commodity options area." 41 Fed. Reg. 51813 (1976). In support of its position, the Commission points out that a FCM dealing only in futures contracts must reassess its position on a daily basis in light of unrealized gains and losses on its customers' contracts. Also, industry self-regulatory organizations, which monitor futures dealers, can detect early signs of a firm's financial instability. We cannot say that the Commission's judgment was arbitrary.

Regarding the inclusion of customers' equity as part of aggregate indebtedness, there has been some confusion among the parties as to precisely what the requirement is. In affidavits filed with the district court on December 3, 1976, and with this court on January 13, 1977, counsel for

[18] Brief of appellants British American and Lloyd, Carr at 44.

British American indicated that the difficulty had arisen from conflicting agency interpretations of the requirement. On December 1, 1976, the Acting Branch Chief of the Commission's Eastern Regional Office wrote to Crown Colony Options, Ltd., that the "haircut" was required by § 1.17. Yet on December 3 the Commission's auditing staff began applying a policy of not requiring the "haircuts" when the FCM acts solely as an agent. And in this court the Commission has again conceded that unrealized gains on options contracts will not be treated as amounts payable to customers for purposes of the net capital computation. With the Commission's position thus clarified, plaintiffs' claim evaporates.

Other Claims

NASCOD argues that the record-keeping requirements in § 32.7 may be unnecessary, especially the requirement that the FCM maintain a list of all prospective commodity option customers to whom solicitations are directed. We accept the Commission's justification that

> This provision imposes no greater burden than placing a check mark next to the name and address of the customer on the solicitation list utilized. Moreover, the Commission believes that this information, as well as its books and record-keeping requirements generally, will assist in the Commission's monitoring of the activities of persons offering commodity option transactions for compliance with the interim rules.

41 Fed. Reg. 51813 (1976).

Plaintiffs claim throughout that the district court erred in granting summary judgment because issues of material fact remained unresolved. In sum, we are told that

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"genuine material questions of fact were raised concerning whether the Commission acted arbitrarily and capriciously." [19] But it is quite clear, as we have already held, that the Commission's actions were not arbitrary or capricious. If plaintiffs' contention is that the district court was required to hear new evidence on the justification for the regulations issued by the Commission, we do not agree. See *Citizens to Preserve Overton Park, Inc.* v. *Volpe,* 401 U.S. 402, 414-15 (1971). Plaintiffs have also advanced other arguments, which we have considered and found to be without merit. Accordingly, the judgment of the district court is affirmed except for the grant of injunctive relief against the segregation requirement, and as to that portion of the order we reverse.

[19] Brief of appellants NASCOD, et al. at 10.

Appendix D

(Order of Court of Appeals Dated June 8, 1977)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 77-6010

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the sixth day of June, one thousand nine hundred and seventy-seven.

Present:

HON. WILLFRED FEINBERG,
HON. MURRAY I. GURFEIN,
HON. THOMAS J. MESKILL,
Circuit Judges.

BRITISH AMERICAN COMMODITY OPTIONS CORP.,
& LLOYD, CARR & CO.,

Plaintiffs-Appellants-Appellees,

v.

WILLIAM T. BAGLEY, ETC.,

Defendants-Appellees-Appellants.

Appendix D

NATIONAL ASSN. OF COMMODITY OPTION DEALERS, ETC.,

Plaintiffs-Appellees,

v.

THE COMMODITY FUTURES TRADING COMMISSION, ETC.,

Defendants-Appellees-Appellants.

A petition for a rehearing having been filed herein by counsel for the BRITISH AMERICAN COMMODITY OPTIONS CORP., AND LLOYD, CARR & Co.

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

/s/ A. DANIEL FUSARO
A. Daniel Fusaro,
Clerk

Appendix E

(Order of Court of Appeals Dated June 14, 1977)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 14th day of June, one thousand nine hundred and seventy-seven.

Docket No. 77-6010

BRITISH AMERICAN COMMODITY OPTIONS CORP.
and LLOYD, CARR & Co.,

Plaintiffs-Appellants-Appellees,

v.

WILLIAM T. BAGLEY, Chairman of the Commodity Futures Trading Commission, JOHN V. RAINBOLT, III, Vice Chairman of the Commodity Futures Trading Commission, et al.,

Defendants-Appellees-Appellants.

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS,
a non-profit association, et al.,

Plaintiffs-Appellees,

NATIONAL ASSOCIATION OF COMMODITY OPTION DEALERS, etc.

Appendix E

It is hereby ordered that the motion made herein by counsel for the appellants British American Commodity Options Corp. and Lloyd, Carr & Co. by notice dated June 7, 1977 to stay issuance of the mandate pending application to the Supreme Court of the United States for a writ of certiorari pursuant to Rule 41(b) of the Federal Rules of Appellate Procedure be and it hereby is granted, subject to the provisions of FRAP 41(b);

It is further ordered that, within five days from the date hereof, appellants post the bonds referred to at p. 9 of the moving papers.

/s/ WILFRED FEINBERG
Wilfred Feinberg

/s/ MURRAY J. GURFEIN
Murray J. Gurfein

/s/ THOMAS J. MESKILL
Thomas J. Meskill
Circuit Judges.

Appendix F

(Principal Statutes Involved)

1. 5 U.S.C. § 553(d):

"The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except—

(1) a substantive rule which grants or recognizes an exemption or relieves a restriction;

(2) interpretative rules and statements of policy; or

(3) as otherwise provided by the agency for good cause found and published with the rule."

2. 5 U.S.C. §706 in pertinent part provides:

"To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall—

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions of law *found to be*—

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory rights;

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(D) without observance of procedure required by law;

(E) unsupported by substantial evidence in a case subject to sections 556 or 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or . . .

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule or prejudicial error."

3. 7 U.S.C. §6c(b):

"(b) No person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this chapter, but not specifically set forth in section 2 of this title, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time. Provided, That any such order,

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rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets."

4. 7 U.S.C. §19 provides:

"The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this chapter, as well as the policies and purposes of this chapter, in issuing any order or adopting any Commission rule or regulation, or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 21 of this title."

Appendix G

(Principal Regulations Involved)

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§32.3 *Unlawful commodity option transactions.*

(a) On and after January 17, 1977, it shall be unlawful for any person to accept any money, securities, or property (or to extend credit in lieu thereof) from an option customer as payment of the purchase price in connection with a commodity option transaction unless such person is registered as a futures commission merchant under the Act and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked.

(b) On and after January 17, 1977, it shall be unlawful for—

(1) any person to solicit or accept orders (other than in a clerical capacity) for the purchase or sale of any commodity option, or to supervise any person or persons so engaged, unless such person is—

(i) registered as a futures commission merchant under the Act, or

(ii) if such person is an individual, registered as an associated person of a specified futures commission merchant under the Act;

and such registration shall not have expired, been suspended (and the period of suspension has not expired) or revoked; and

(2) any futures commission merchant to permit an individual to become or remain associated with such futures commission merchant as a partner, officer or employee (or in any similar status or position involving similar functions) in any capacity involving such solicitation, acceptance or supervision if such futures commission merchant knew or should have known that such individual was not registered as an associated person or that such registration has expired, been suspended (and the period of suspension has not expired) or revoked; . . .

• • • • •

§32.4 *Exemptions.*

• • • • •

(b) The Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of this Part, other than sections 32.2, 32.8 and 32.9, if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption.

• • • • •

§32.6 *Segregation.*

(a) Any person which accepts money, securities or property from an option customer as payment of the purchase price in connection with a commodity option transaction shall treat and deal with such money, securities and property as belonging to such option customer until expiration of the term of the option or, if the option customer exercises the option, until all rights of the option customer under the commodity option have been fulfilled. Such money, securities, and property (1) shall be separately accounted for and segregated as belonging to such option customer, (2) shall be kept in the United States, and (3) shall not be commingled with the money, securities or property of any other person, including the money, securities

or property received by a futures commission merchant to margin, guarantee or secure the trades or contracts of commodity customers (as defined in §1.3(k) of this chapter) or with the money accruing to such commodity customers as the result of such trades or contracts: *Provided, however,* That the money, securities or property treated as belonging to an option customer may for convenience be commingled with the money, securities or property treated as belonging to any other option customer and deposited in the same account or accounts with any bank or trust company in the United States. Such money, securities and property, when so deposited with any bank or trust company, shall be deposited under an account name which will clearly show that it contains money, securities or property, segregated as required by this Part. Each person depositing such money, securities or property shall obtain and retain in its files for the period provided in §1.31 of this chapter an acknowledgment from such bank or trust company that it was informed that the money, securities and property therein are being treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such bank or trust company shall allow inspection of such accounts at any reasonable time by representatives of the Commission: *Provided, further,* That, up to a maximum of 10 percent of the money, securities or property accepted from an option customer as payment of the purchase price in connection with a commodity option transaction need not be treated and dealt with as belonging to the option customer and segregated as aforesaid.

(b) No money, securities or property deposited in accordance with paragraph (a) of this section shall be held, disposed of, used or treated as belonging to the depositing

person or any person other than the option customers of such person: *Provided, however,* That such money may be invested in obligations of the United States, and in obligations fully guaranteed as to principal and interest by the United States. Such investments shall be made through an account or accounts used for the deposit of money, securities or property received from option customers and proceeds from any sale of such obligations shall be redeposited in such account or accounts. Each person which invests money belonging to option customers in obligations as described in this paragraph (b), shall separately account for such obligations and segregate such obligations as belonging to such option customers. Such obligations may only be deposited with a bank or trust company in the United States and shall be deposited under an account name which will clearly show that it contains obligations treated as belonging to option customers, segregated as required by this Part. Each person depositing such obligations shall obtain and retain in its files an acknowldgment from such bank or trust company that it was informed that the obligations are treated as belonging to option customers and are being held in accordance with the provisions of this Part. Such acknowledgment shall be retained for the period provided in §1.31 of this chapter. Such bank or trust company shall allow inspection of the obligations at any reasonable time by representatives of the Commission.

(c) Each person which invests money treated as belonging to option customers as permitted hereunder shall keep a record showing the following: (1) the date on which such investments were made, (2) the name of the person through which such investments were made, (3) the amount of money so invested, (4) a description of the obligations

in which such investments were made, (5) the identity of the depositories or other places where such obligations are segregated, (6) the date on which such investments were liquidated or otherwise disposed of and the amount of money received on such disposition, if any, and (7) the name of the person to or through which such investments were disposed of.

(d) Persons which invest money in obligations described in paragraph (b) of this section shall include such obligations in segregated accounts at values which at no time shall be greater than current market value, determined as of the close of the market on the last preceding market day.

(e) The deposit and/or investment of money as provided in paragraphs (a) or (b) of this section shall not operate to prevent the person so depositing and/or investing such money from receiving and retaining as its own any increment or interest resulting therefrom.

(f) The amount of money, securities and property which is and which must be in a segregated account in order to comply with the requirements of this Part shall be computed by each person required to segregate such money, securities and property as of the close of each business day. A record of such computation shall be made and kept, together with all supporting data in accordance with the provisions of §1.31 of this chapter. Such computation shall be made prior to the opening of business on the next business day.

§32.10 *Option transactions entered into prior to the effective date of this Part.*

Nothing contained in this Part shall be construed to affect any lawful activities that occurred prior to the effective date of this Part.

The foregoing adoption by the Commission of the amendments to §§1.3 and 1.17, of the deletion of §30.01, and of Part 32 shall become effective 15 days after the date this Notice is published in the *Federal Register* (December ...., 1976), except that section 32.6 of Part 32 of the foregoing rules shall become effective 30 days after the date of publication (December ...., 1976). In order to assure full and fair consideration of the various proposals that have been made over the many months in which option regulations have been considered, it has not been possible to implement appropriate regulations before now. That consideration having now been completed, however, the Commission finds that the public interest requires that the foregoing rules be adopted without any further delay inasmuch as the public has been without the protection of a comprehensive regulatory program in an area which historically has been fraught with abuses. Moreover, there has been ample notice and public participation in this rule-making proceeding and affected persons have had adequate notice and opportunity to comment on the subject of these rules and the issues involved in their consideration, as well as the terms of the rules themselves substantially as adopted. Furthermore, affected persons have had an adequate opportunity, through prior notices, to take the necessary steps to be in full compliance with the rules by the effective dates thereof.

Issued in Washington, D.C. on November 22, 1976.

By the Commission.

/s/ William T. Bagley
William T. Bagley
Chairman
Commodity Futures Trading
Commission

Appendix H

(Order of Court)

IN THE

UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF GEORGIA

ATLANTA DIVISION

C77-643A

FRANKLAND COMMODITIES CORPORATION,

Plaintiff,

v.

COMMODITY FUTURES TRADING COMMISSION, et al.,

Defendants.

This is an action for injunctive and declaratory relief brought by Frankland Commodities Corporation (Frankland) against the Commodity Futures Trading Commission (CFTC) and the five individual Commissioners of the CFTC. Jurisdiction is founded upon 28 U.S.C. §§ 1344 (a)(2), 2201, and 2202 and the Administrative Procedure Act, 5 U.S.C. §§ 551 and 553. Frankland seeks to enjoin the enforcement of the segregation requirements contained in 17 C.F.R. § 32.6. Frankland also seeks a declaratory judgment on the grounds that the segregation provision is null and void on the basis that it is arbitrary, capricious, anticompetitive, void for vagueness, contrary to public policy and that it will deprive plaintiff of its property without due process of law. The Court, having heard

oral argument on May 5, 1976, presently has before it Frankland's motion for a preliminary injunction.

On October 23, 1974, Congress enacted the Commodity Futures Trading Commission Act of 1974 (Act), Pub. L. 93-463, 88 Stat. 1389, which established the CFTC as an independent regulatory agency of the United States charged with the responsibility for enforcing and administering the provisions of the Act.

The commodities business involves the trading of contracts for the purchase or sale of specific amounts of a commodity either that have already been produced, or that will be produced in the future and delivered by a specific date. The latter group of contracts are known as "commodity futures" and are freely traded in the commodities marketplace. A "commodity option" is a contractual right to buy or sell a commodity or commodity future by some specific date at a specified price. Generally, an option is created, or "written," by the owner, or "grantor," of a commodity or commodity futures contract, who obligates himself to sell his goods or contract.

Frankland does not engage in the sale of commodities or commodity futures, but rather, deals only in options on futures contracts for certain commodities that are traded in London, England. Frankland solicits customers for London options only in the United States. Once Frankland obtains an order for an option, Frankland requires that its customer pay Frankland in full for the retail value of the option. According to plaintiff, when Frankland receives the customer's money it purchases the option from a trader on the London Option Market. Frankland's cost for its options is approximately 72 percent of the amount it receives from its customers, the remaining 28 percent becoming profit.

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The London Option Market is composed of members of the International Commodity Clearing House (ICCH) and the London Metal Exchange (LME). After execution of the option the grantor is required to escrow or segregate 100 percent of the price of the option in special accounts with the ICCH which guarantees fulfillment of each futures option executed by its members.

In October 1975, the CFTC announced that it was considering rules to regulate or prohibit all options trading under the authority granted to it under the Commodity Futures Trading Commission Act, 7 U.S.C. § 12a(5) (Supp. V, 1975), and invited public comment. 40 Fed. Reg. 49360-49362 (October 22, 1975). On February 20, 1976, the CFTC published proposed temporary rules to govern commodity options transactions. 41 Fed. Reg. 7774-7776 (February 20, 1976). These proposed temporary regulations did not include a requirement that the United States option dealer escrow or segregate any portion of the customer's cash payment until the option is sold or exercised. However, the CFTC did indicate its interest in comments on such a requirement. 41 Fed. Reg. 7776 (February 20, 1976).

On October 8, 1976, the CFTC published proposed interim regulations, which included a segregation requirement, and invited public comment. 41 Fed. Reg. 44560, 44561, 44567 (October 8, 1976). The CFTC adopted these regulations, substantially in the same form as proposed, and gave public notice on November 24, 1976. 41 Fed. Reg. 51808-51810, 51815-51816 (November 24, 1976). The effectiveness of the segregation requirement was delayed 30 days.

Section 32.6 of these regulations requires a futures commission merchant, such as Frankland, to segregate 90 per-

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cent of the payment received from the customer in a United States bank account until expiration or exercise of the option. But the London exchanges must simultaneously be sent that portion of the customer's money that represents the wholesale price of the option. Frankland, therefore, must itself have the funds to place a major portion of the price of the option it sells in a segregated account in the United States. Frankland contends that this "double segregation" burden will require it to raise approximately 189,000 dollars per month, which may be impossible for it to raise. See Affidavits of C. Jeffery Jacobs and Don F. Barnes (filed May 5, 1977). Plaintiff claims that the segregation regulation is anticompetitive in that it will force small futures commission merchants out of business and allow only the large houses, with substantial capital bases, to remain operating. Frankland further contends that the segregation requirement is not needed to protect American investors inasmuch as the London market has its own system of customer safeguards.

The Second Circuit, in *British American Commodity Options Corp., et al.* v. *Bagley, et al.*, Civil Action Nos. 77-6010, 77-6011, 77-6019 (April 4, 1977), has upheld the segregation requirement under attack in the instant action, and the plaintiffs in that case have filed petitions for rehearing. The Second Circuit seriously questioned the protection afforded United States customers by the London safeguards and found that the segregation requirement was a reasonable exercise of the CFTC's discretion in an effort to protect the public from the abuses that have plagued the commodity options industry.

In weighing any request for preliminary injunction, this Court must be guided by the standards set forth by the United States Court of Appeals for the Fifth Circuit in

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Canal Authority of State of Florida v. *Callaway,* 489 F.2d 567 (1974). The Court of Appeals there noted that, although the granting of a preliminary injunction is discretionary, the district court must exercise that discretion in the light of four prerequisites:

> "The four prerequisites are as follows: (1) a substantial likelihood that plaintiff will prevail on the merits, (2) a substantial threat that plaintiff will suffer irreparable injury if the injunction is not granted, (3) that the threatened injury to plaintiff outweighs the threatened harm the injunction may do to defendant, and (4) that granting the preliminary injunction will not disserve the public interest." (citation omitted)

489 F.2d at 572.

The Court of Appeals has also stressed the extraordinary character of such relief:

> "In considering these four prerequisites, the court must remember that a preliminary injunction is an extraordinary and drastic remedy which should not be granted unless the movant clearly carries the burden of persuasion. The primary justification for applying this remedy is to preserve the court's ability to render a meaningful decision on the merits." *Id.* (citation omitted)

Those standards are set forth in recognition of the fact that the district court must decide whether to grant the interim relief of a preliminary injunction without the benefit of full discovery and consideration of the issues on the merits that would occur at trial.

The Court is not entirely persuaded by the decision of the Second Circuit and, therefore, is not of the opinion

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that plaintiff has not presented a substantial cause of action. The Court does find, however, that Frankland has not presented the Court with sufficient evidentiary documentation of the irreparable injury that will be caused by the enforcement of the segregation regulation and, therefore, finds that Frankland has failed to carry its burden of persuasion, as required by the Fifth Circuit, regarding the threat of irreparable injury. Accordingly, plaintiff's motion for a preliminary injunction is hereby DENIED.

So ORDERED, this 12 day of May, 1977.

/s/ CHARLES A. MOYE, JR.
United States District Judge

Appendix I

(Order Granting Injunction Pending Appeal)

IN THE

UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF GEORGIA

ATLANTIC DIVISION

Civil Action File No. 77-643A

FRANKLAND COMMODITIES CORPORATION,

Plaintiff,

vs.

COMMODITY FUTURES TRADING COMMISSION, et al.,

Defendants.

This cause came on to be further heard on motion of plaintiff for an injunction pending appeal, and it appearing to the Court that the relief herein granted is necessary to preserve the status quo pending appeal by the plaintiff to the U. S. Court of Appeals for the Fifth Circuit for the reason that irreparable damage will result to the plaintiff pending such appeal if the denial of plaintiff's motion for preliminary injunction shall be reserved on appeal,

IT IS ORDERED that (provided Notice of Appeal is filed by May 17, 1977 and prosecuted diligently and expeditiously thereafter) until a hearing and determination of the appeal herein to the U. S. Court of Appeals for the Fifth Circuit, the defendants be and hereby are restrained from

enforcing their Rule 32.6 (17 CFR §32.6) as to plaintiff, and that the security in the amount of $25,000.00 deposited with the Clerk of the Court by plaintiff as a condition of the temporary restraining order issued in this action shall continue to be deposited with the Court as security for this injunction pending appeal conditioned upon the faithful performance by plaintiff of its obligations to its customers.

IT IS SO ORDERED this 12 day of May, 1977.

/s/ CHARLES A. MOYE, JR.
Charles A. Moye, Jr.,
Judge, United States District Court, Northern District of Georgia